



# Global Markets Monthly

JANUARY 2023

**MUFG Bank, Ltd. & MUFG Securities EMEA**  
Members of MUFG, a global financial group



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25 January 2023

## Contents

Global Macro – Emerging Markets	3
2022 was another year to forget	3
A tale of two halves in 2023	4
Six key risks in 2023	5
EM opportunities	6
US Fixed Income: 2023, a strong start, can it last?	7
US Macro and Fed views	8
US IG Credit: VOLATILE start to A volatile year Ahead	9
FX Outlook	12
Base case expectations, JPY, EUR & CNY	12
USD/JPY – Neutral Bias	12
EUR/USD – Bullish Bias	14
USD/CNY – Neutral Bias	15
Key risk factors in the month ahead	16
European Credit	17
2023 kicks off much more positively	17
European Banks	18

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## Global Macro – Emerging Markets

2022 was a year to forget for emerging markets. A taxing external backdrop marred by the reverberations of the pandemic, the war in Ukraine, supply chain challenges, slowing growth, rising inflation and an aggressive tightening of monetary policy by global central banks clocked up solid negative returns across the complex. Whilst EMs continue to grapple with much the same themes at the turn of the year, we view the outlook as a tale of two halves in 2023. A fading boost from reopenings, a global manufacturing cycle downturn and tighter financial conditions are lumpy headwinds that will weigh on emerging market prospects in H1 2023. However, China's zero COVID policy exit, the eventual end of rate hikes and a US dollar peak, all offer significant tailwinds to the emerging markets space in H2 2023. [See here for our emerging markets 2023 outlook.](#)

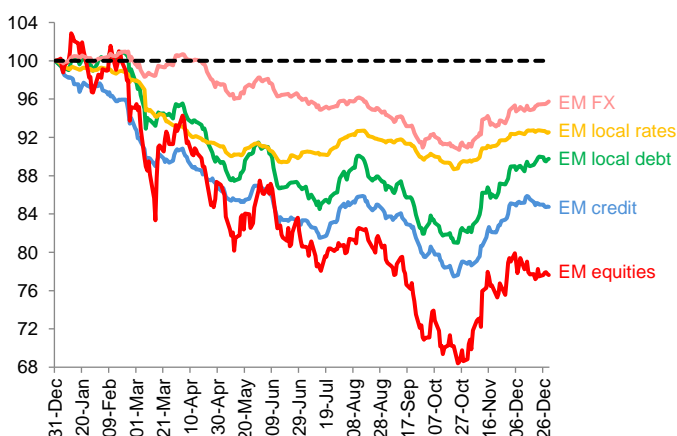
### 2022 WAS ANOTHER YEAR TO FORGET

There was no respite for EMs last year. Expectations were already rather downbeat heading into 2022, but it turned out to be even worse than expected as EM faced severe headwinds, causing frequent episodes of elevated stress in financial market. As a result, EM had one of the worst years since the global financial crisis (GFC), with all EM assets posting double-digit losses, except for EM FX. Granted, there was a sharp and encouraging recovery in the last quarter of 2022, given the favourable valuations and technicals as well as expectations of a pivot from core central banks with signs of inflation peaking. Having said that, this was not enough to reverse the downtrend that started in 2021.

In tandem, portfolio flows into EM were also frail last year, given global liquidity tightened on the back of the Fed's quantitative tightening alongside a stronger USD that reduced the balance sheet size of other major central banks in USD terms. Less favourable liquidity conditions have had an impact on EM secondary markets, which has been clearly seen not only in EM fund outflows but also in balance of payments data. Yet, the eventual end of rate hikes, signals a rebound in EM flows is emerging.

#### ALL EM ASSET CLASSES WITNESSED DOUBLE-DIGIT DECLINES IN 2022 BAR EM FX DOWN 4.6%

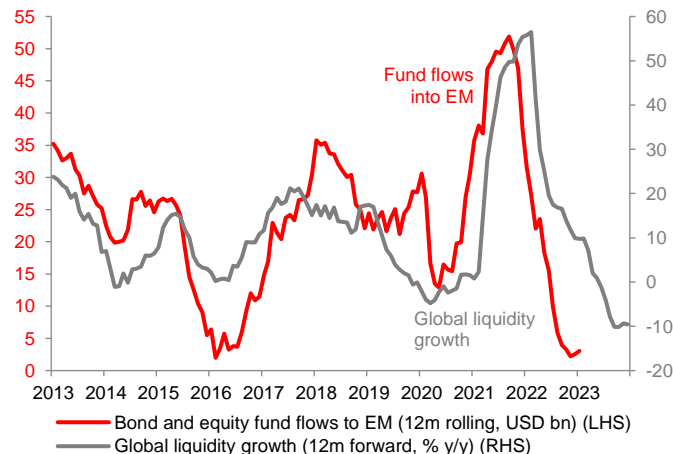
EM ASSET CLASS PERFORMANCE IN 2022 (REBASED = 1 JAN 2022 = 100)



Source: Bloomberg, MUFG Research

#### GLOBAL LIQUIDITY GROWTH HAS TURNED SHARPLY NEGATIVE, ACCELERATING EM FUND OUTFLOWS

GROWTH IN G4 BALANCE SHEETS (% Y/Y) VS EM FUND FLOWS (USD BN)



Source: Bloomberg, BoJ, ECB, Fed, PBoC, MUFG Research

## A TALE OF TWO HALVES IN 2023

Distressingly high inflation, aggressively elevated interest rates, the war in Ukraine, sticky COVID outbreaks in China and a dominant US dollar dented the performance of EMs in 2022. Whilst EMs continue to grapple with much the same themes at the turn of the year, we view the outlook as a tale of two halves in 2023. A fading boost from reopenings, a global manufacturing cycle downturn and tighter financial conditions are lumpy headwinds that will weigh on EM prospects in the first half of 2023. However, China's zero COVID policy exit, the eventual end of rate hikes and a US dollar peak, all offer significant tailwinds to the EM complex in the second half of 2023.

Differentiation has often been a theme in EMs post-COVID, and we expect high dispersion again in 2023 given varied sensitivities across the space to global growth softness, continued commodity buoyancy, and potential further core interest rate pressures. There are unambiguous winners and losers:

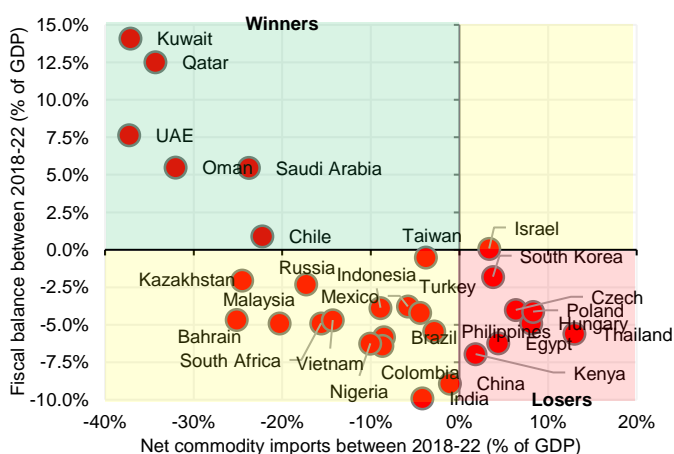
- **Losers.** On the losing side are economies that import expensive commodities and run trade deficits they must finance at high interest rates. Some have found it difficult to do so. Sri Lanka defaulted on its debt, Egypt has devalued its currency by ~60% since last March and the IMF stepped in to help both countries as well as Pakistan, Tunisia amongst several other smaller EMs that face the fire of sovereign defaults (see [here](#)).
- **Winners.** Commodity exporters remain the winners. The export windfall for these countries – the GCC region and a host of LatAm nations – has helped post sizable surpluses, support government spending and grow rapidly.

With a sharp fall in commodity prices since June 2022 and easing supply-side pressures, headline inflation seems to have peaked across many economies around the world and the upside inflation surprises have diminished. If anything there have been a few downside surprises recently, both in EM and DM. However, the improving outlook on headline inflation is yet to reflect in core inflation which still is elevated.

Furthermore, monetary policy appears to be more predictable now, particularly when compared to last year. 2022 started with global central banks, led by the Fed, trying to hike fast to catch up with uncomfortably high inflation. After significant monetary tightening and falling headline inflation, there now seems to be less need for aggressive hikes and central banks will likely observe the cumulative impact of earlier rate increases. Yet, in our view the inflation slowdown does not merit rate cuts, nearly across the entire EM complex, in 2023.

### EM WINNERS AND LOSERS FROM PRICEY COMMODITIES AND RISING RATES

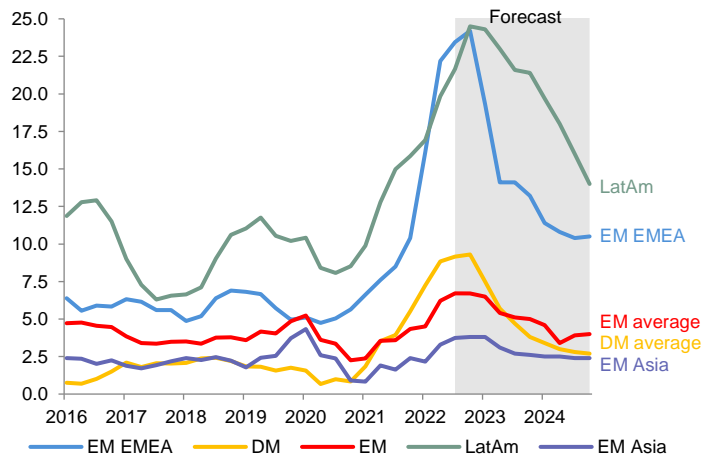
EM NET COMMODITY IMPORTS AND FISCAL BALANCE (% OF GDP)



Source: Bloomberg, EM Statistical Offices, MUFG Research

### FROM PEAK CONCERNS TO DURATION CONCERNS FOR EM INFLATION – TARGETS NOT REACHED IN 2023

HEADLINE CPI INFLATION FOR DM, EMS AND EM REGION (% Y/Y)



Source: Bloomberg, EM Statistical Offices, MUFG Research

From an economic growth perspective, our modelling estimates signal a rise in EM GDP from an estimated 3.1% in 2022 to 4.0% in 2023 and thereafter rising to 4.4% in 2024. This is predominantly owing to robust Chinese growth on the back of reopenings and measures to support the real estate sector. Also, the eventual easing in financial conditions as well as still elevated commodity prices will offer support to growth.

Whilst a synchronised global recession is increasingly unlikely, some DM economies – notably the EU and UK – may witness a recession, albeit on the margins. With the IMF pointing to an estimated 1.1% real GDP growth for DMs, this suggests the EM's growth increment over DM is set to widen to 2.9ppts this year – the highest level in a decade – which should help drive fund flows into EMs, given this is one of the main pull drivers of capital into the complex. Indeed, our estimates suggest that for every 1ppt improvement leads to ~1.2% of GDP (or ~USD500bn) in capital inflows into EMs.

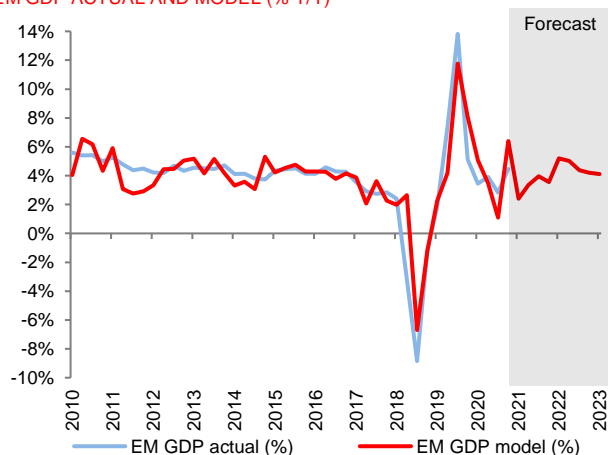
## SIX KEY RISKS IN 2023

The 2023 backdrop is better than the challenging environment which hampered EM appetite in 2021 and 2022. Nonetheless, we also find many reasons why the risk rally may not be such smooth sailing and the macro backdrop could get more complicated:

1. **Global monetary policy could disappoint.** US core inflation could prove sticky delaying rate cuts. The US labour market remains strong, with the unemployment rate still hovering at multi-decade lows, while wage pressures – despite signs of thawing, still remain elevated, posing risks to deflation. Also, policy normalisation just seems to have started in Japan, which could prevent global yields from falling further. A similar risk applies to China.
2. **Inflationary pressures could re-accelerate.** China's reopening risks spurring commodity prices higher and with it renewed cost side pressures. More broadly, an acceleration of decarbonisation is long-term inflationary given supply constraints (see [here](#)).

### OUR EM GDP GROWTH MODEL SIGNALS A SLOWING IN H1 2023 FOLLOWED BY A REBOUND IN H2 2023

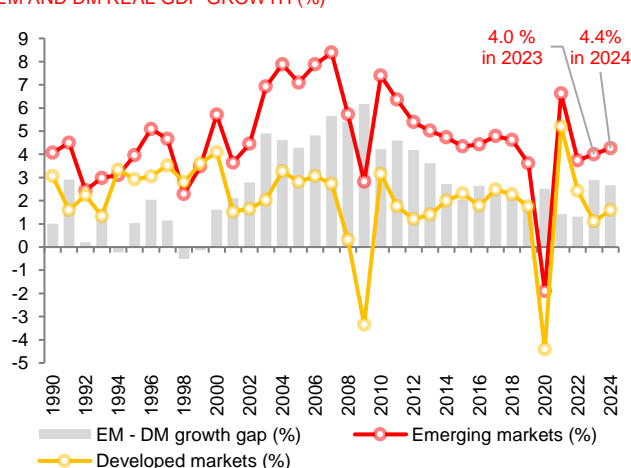
EM GDP ACTUAL AND MODEL (% Y/Y)



Source: Bloomberg, MUFG Research

### EM'S GROWTH DIFFERENTIAL WITH DM TO WIDEN TO THE HIGHEST LEVEL (2.9PPTS) SINCE 2013 THIS YEAR

EM AND DM REAL GDP GROWTH (%)



Source: Bloomberg, MUFG Research

3. **Withdrawal of global liquidity likely to accelerate.** The ECB will soon start its own QT, akin to the Fed-style partial reinvestment to ensure a steady run-down of the balance sheet, with an average monthly pace of EUR15bn

during Q2 2023. Our examination suggests a lagged impact on EM capital flows (albeit non-linear) from the rate of change in global USD liquidity.

4. **Hard landing concerns linger.** Economic activity could remain soft on the back of the lagged impact of previous aggressive monetary tightening and fading boost from reopening in DMs. From an EM perspective, growth indicators imply solid economic activity, thanks to the expected growth rebound in China. Having said that, tight financial conditions still argue for visible downside risks in the medium-term.
5. **Limited policy support.** Policy is limited – real policy rates remain in negative territory in large EMs with no room for cuts. We expect EM's financing requirements (accounting also for maturing debt) and fiscal balances of USD2.3tn (8.5% of EM GDP) in 2023.
6. **Public finances could be the next dividing line across EMs.** Higher rates, lower liquidity, slower growth and a still strong USD signal are all a bad combination for EM debt. Higher inflation may be good for a short-term gain in nominal growth but it can lead to larger pain in the long-term. Most EMs need to tighten fiscal policy to stabilise debt to GDP ratio.

## EM OPPORTUNITIES

The EM outlook remains challenging given uncomfortably high inflation, slow growth and DM recessionary risks. At the same time, while asset valuations across EMs are undemanding, they are not consistent with historical bear market troughs after EM early hikers already outperformed in 2022 and the gap between EM local rates and US yields has compressed (after widening during EM's hikes of 2021). Consequently, expectations are for low, positive returns for the major EM indices, without significant outperformance against DM peers – akin to previous market recoveries:

1. **EM local rates – thin buffers on aggregate, opportunities within.** Despite the historic sell-off of the last 12 months, EM local rates have significantly outperformed core markets. This outperformance is unusual in a risk-off year like the past one, and it means that 2023 may well provide a mirror image – EM rates may rally in sympathy with an eventual core duration rally but, with thin valuation buffers, will struggle to outperform relative to core markets.
2. **EM FX – relative value in a US cycle extension.** After resilience vs the G9, we consider the bar for further EM FX outperformance is higher. Near-term, as we are in the midst of a messy USD peak, positive carry, risk-neutral relative value opportunities still appear to be the best option. Weak macro favours relative underperformance of CZK, HUF, PLN, RON and TRY. Whilst BRL and MXN offer attractive real rates with inflation more under control.
3. **EM equities – rotation into EM Asia, but DM high bar to beat.** MSCI EM is coming from a unique place – half the index (North Asia) significantly underperformed DM in 2022, and the other half outperformed. We expect this trend to reverse in 2023.
4. **EM credit – wider spreads, but high carry to drive positive total returns.** Increasing left-tail risks and rising UST yields drove the worst annual total return performance for the EMBI Global Diversified index since its inception. Though, excluding sovereigns in distress, spreads have been resilient and have outperformed DM peers. This leaves spreads with a tough risk/reward in 2023, and we expect spreads to widen slightly – total returns are likely to be positive, driven by the carry.

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## US Fixed Income: 2023, a strong start, can it last?

Macro Review: Since inflation has been enemy number one and what catalysed central banks into action, now that inflation has peaked the market is excited that the turn in inflation is all that is needed to return to the prior state of being for the large developed economies. Meanwhile in the US the list of data indicators that are suggesting the US is in or close to slipping into a recession keep growing. We had the services sector ISM break under 50 in December, industrial production collapsed and retail sales (for the key holiday shopping season) came in super weak.

Fed Policy: At the December FOMC meeting the Fed reduced its size of rate hikes by 25bps, from 75 bps to 50bps. It is largely consensus that the Fed will reduce the size of its hikes again at the upcoming meeting. We agree with this as well and expect the Fed to continue this step-down process by once again reducing hikes by 25bps, from 50bps to 25bp hikes. This will bring rate changes back to the historical normal of 25bps at a time and allow the Fed to potentially hike 2-3 more times this year. The market is also pricing to such an outcome with only about 2.5 times more 25bps hikes priced into forward rates. Where the March and May meetings are now pricing for the first time the change of no hikes too.

In our view the focus should shift from where the terminal rate will ultimately rest at (it could be somewhere between 4.875-5.125%) to how long can the Fed keep rates on hold at such high levels. Chair Powell and other Fed speakers have emphasized that the combination of the long and variable lags of the fast tightening of 2023 (where they hiked 425bps in 7 meetings) along with the high level of rates (again if they get to around 5%) will continue to tighten conditions into the foreseeable future. They also believe that their messaging of keeping rates “higher for longer” and at a restrictive interest rate will help to reign in inflation.

The real question concern is if financial conditions, because there is still excess liquidity in the system, do not tighten further and that helps fuel financial inflation/wealth effect gets a boost, and that then takes a viral jump back into actual inflation in the real economy. At that point the Fed might need to lean more heavily on its balance-sheet and enhance QT.

Rates Views: We basically have a fully inverted curve and the levels of bond yields and even T-bills versus the Fed Funds rate (and more importantly where the Fed Funds rate is likely heading to – around 5%) are all trading much lower in rates. The market is expecting the Fed to turn around and cut rates quickly after the Fed is done, that is allowing for these deep inversions to exist. Although we agree with these views over the long-term, but we also think the bond market is too early in pricing this in. We think the next two hikes can still drag up overall rates.

Credit Views: IG spreads should settle in a higher range in 2023, our 1H23 range forecast is 115–175bps, and in a stress scenario, a move beyond 200bps is within scope. However, given that IG spreads are near the bottom of our range, we would lighten up on credit exposure now.

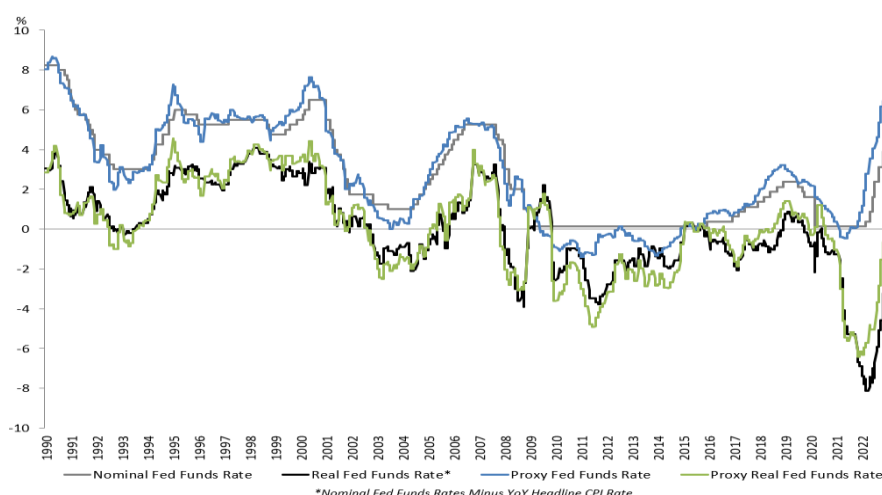
## US MACRO AND FED VIEWS

As 2023 gets going the calls for goldilocks (i.e. soft landing) have been growing by the day, driven primarily by the positive moves in financial markets. Ultimately, we believe this will be another failed attempt at trying to call the bottom in financial markets and the economy. As seen by import/export activity, industrial production and retail sales, US data has only progressively worsened towards the end of 2022.

The Fed has embarked on the fastest hiking cycle since the late 1970s/early 1980s and yet real Fed Funds is still negative. Now, granted inflation is coming down and at some point, the level of inflation may come under the level of Fed Funds, but for now its not. Even if we take a more generous version of the Fed Funds rate, a proxy rate from the San Francisco Fed (see [link](#)) which takes into account other financial variables to convert to an implied Funds rate impacting interest rate sensitive sectors, even that is still negative in real terms. So is the Fed Funds rate restrictive enough?

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### FED FUNDS COMPARISON: NOMINAL VS PROXY, REALS ARE STILL NEGATIVE



Source: Bloomberg, MUFG US Macro Strategy

**February FOMC Meeting Preview:** The first FOMC meeting of 2023 will conclude on February 1<sup>st</sup> and in our view, we will likely see another downgrade in the size of the Fed hikes, moving from 50bps down to 25bps. However, we expect chair Powell to remain hawkish and suggest the job isn't done until it's clear that inflation is on track to 2%. So even though the hiking size is slowing once again at this meeting, chair Powell will try to deliver as hawkish of a 25bp hike as possible. How so exactly? Well chair Powell can emphasize that the current pricing of rate cuts following these hikes seems premature and inconsistent with the macro-enviro. And that this financial market reaction to the end of Fed hikes is leading to financial conditions easing that is countering the Fed's goals. Perhaps he can say that they plan to devise a way to tighten via forward guidance and maybe balance-sheet/QT tweaks.

**Market Implications:** The markets have had a strong start to the year and that along with the China reopening narrative has introduced optimism that the worst is behind us. We believe this is misplaced excitement and that the big moves in markets is more likely attributed to positioning adjustment (both short-covering and asset allocation moves that take place at the start of the year) along with cash that got put to work after a rough 2022 forced many to the side-lines. This makes the upcoming FOMC meeting critical. Each of the last FOMC meetings have seen markets sell-off during and after chair Powell speaks. He has managed to deliver a hawkish message each time that ends up turning markets lower. We do not believe he wants to endorse the Fed pivot so early on in the year. The risk is markets have gotten ahead of reality again. We expect a retracement in stocks, credit and duration post Fed.



## US IG CREDIT: VOLATILE START TO A VOLATILE YEAR AHEAD

**Our 2023 views are as follows - previously published in our 2023 Macro2Markets Outlook - Passing the Baton: A shift from inflation to growth concerns:**

- With the Fed aiming to keep raising rates (likely to around 5%) and then holding rates “higher for longer”, the risk is that the 2022 “rate shock” can morph into a 2023 “credit shock”, especially if the economy falls into a recession.
- After having tightened for technical reasons in late 2022, spreads could widen again over the course of 2023 as a slowing economy leads to higher credit risk with weaker EBITDA margins, lower cash balances and rising leverage.
- However, we expect the widening of spreads to increasingly attract cross over buyers. That may lead to a reversal in spreads later in the second half, especially if we finally get a dovish Fed pivot and general risk sentiment improves. The combination of spread tightening and rates declining should lead to favorable total returns for IG credit in 2H23.
- Overall, we believe IG spreads will settle in a higher range than what was seen in 2022. We establish our initial IG credit spread 1H23 range forecast at 115–175bps, and in a stress scenario, a move beyond 200bps is within scope. Managing rate hedges will be key in 2023 as spreads could also widen if/when Treasuries see flight to quality flows. Lastly the wider spreads afforded to MBS (and higher Treasury yields) will likely keep IG spreads wider to compete.
- On the supply front we estimate 2023 IG issuance of about \$1.3 trillion, which is 9% above this past year’s total of \$1.19 trillion but still 12% below the 3-year average of \$1.478 trillion. The likely drivers for increased IG issuance next year is primarily due to pent-up issuance needs (post a lower than average 2022 run rate) the potential for refinancing of debt maturities as well as the potential for increased issuance later in 2H23 if the Fed begins to pivot on its policy.
- After witnessing a very large \$134bn of IG fund outflows this year, we expect flows to turn net positive in 2023, where investors that are searching for high-quality returns will increasingly be compensated for taking on IG credit spread.

**Markets Summary:** 2023 is starting off on a volatile note as concerns about economic growth are beginning to eclipse concerns on continuing Fed tightening. Both equity and IG bond markets are gaining slightly so far in January but it’s been a roller coaster ride. The S&P 500 Index gained a strong 4.2% through mid-January, before giving up part of that in the third week, ending up 3.5%. Still, that’s in stark contrast to the -5.2% loss in January 2022.

Similar to equity markets, IG credit performed better than expected so far in January, posting a total return of 3.52% and excess return of 0.81%. IG credit spreads tightened by 7 bps from 130 to 123, partly due to the equity rally as well as positive net fund inflows and very strong new issuance. (please refer to the chart below for more details)

Markets initially declined at the start of the year after Fed minutes from the December meeting showed that members affirmed their resolve to bring down inflation, cautioning that an “unwarranted” loosening of financial conditions would hurt their efforts to achieve price stability. Also, stronger employment reports early in the month showed a resilient labor market. However, markets quickly reversed course and rallied after several weaker economic reports including factory orders and average hourly earnings that showed evidence that the Fed’s tightening policy may be having an impact. The CPI report came inline but investors took a positive spin and are expecting the Fed to step down its next rate hike to 25 bps on February 1. However, markets again reversed in the third week, as weaker retail sales, industrial

production, and PPI provided evidence of the intended economic slowdown which raised investors' concerns. However, the blow was later softened after several Fed officials gave more dovish hints that monetary policy may be close to being restrictive enough.

Meanwhile, fourth quarter earnings season just started over the past week, so we are still gathering data points on corporate health and financial outlooks. So far, earnings are coming in slightly weaker than expected from the Banking and Transportation sectors. Job layoff announcements also continued to grow in January, with over 60,000 announced in the last month, with the majority coming from the Tech sector. Additionally, several bank CEO's expect at least a mild recession this year but wouldn't rule out a hard landing either.

**Demand Update:** Market participants continue to be quite vigilant and seem to have a cautious tone on credit to start the year. In general, we have heard that some participants think that IG market valuations are too high to add to current positions and new issues are pricing too tight with very little concessions, so they are being highly selective in adding credit risk. Some participants have also told us they expect another sell-off in credit at some point this year and wouldn't be surprised if IG spreads widened out to 170+, which is at the high-end of our spread range. Trading volumes have also been relatively light, reflecting market volatility and economic uncertainty. Credit remains orderly though given the amount of cash on the sidelines, relative yields vs historical levels, as well as the amount of high-quality credit paper trading at deep discounts due to low coupons.

Overall, fund flows have been orderly and started the year on a positive note, with net IG fund flows of positive \$7.9bn, ahead of last year's \$5.5bn. Net outflows for the full year 2022 totaled \$134bn, in stark contrast to 2021's positive inflows of \$135bn. We expect flows to turn net positive in 2023 once investors become more comfortable that financial and economic indicators are close to bottoming. Please refer to the chart below for a recent history of IG fund flows:

#### IG SPREADS, RETURNS, AND EQUITY RETURNS - AS OF 1/20/23

OAS AND SPREAD CHANGES						Total Return		Excess Return	Spread Variance		S&P 500
Sector	OAS	1 Month	YTD	1 Year	YTW	MTD (%)	YTD (%)	YTD (%)	Sector vs Total	Sector 5 Yr Avg Diff	Equity YTD Return
Total IG	123	-7	-7	23	5.00%	3.52%	3.52%	0.81%	-	-	3.5%
Financial Institutions	131	-9	-9	40	5.13%	2.97%	2.97%	0.84%	8	-8	3.3%
Utility	125	-4	-4	15	4.99%	3.90%	3.90%	0.58%	2	-1	-1.8%
Energy	135	-7	-9	14	5.13%	3.92%	3.92%	1.03%	12	38	3.5%
Basic	144	-10	-9	22	5.17%	4.04%	4.04%	1.03%	21	30	6.6%
Capital Goods	106	-4	-4	15	4.83%	3.45%	3.45%	0.76%	-17	-10	0.8%
Technology	105	-5	-6	15	4.80%	3.46%	3.46%	0.63%	-18	-21	5.6%
Communications	149	-9	-11	20	5.19%	4.58%	4.58%	1.32%	26	27	11.4%
Consumer Noncyclical	108	-5	-6	13	4.83%	3.84%	3.84%	0.73%	-15	-8	-2.5%
Pharmaceuticals	89	-5	-5	6	4.65%	3.87%	3.87%	0.68%	-34	-19	-1.4%
Food/Beverage	108	-5	-6	11	4.80%	3.91%	3.91%	0.75%	-15	-4	-2.5%
Consumer Cyclical	100	-4	-4	14	4.77%	3.01%	3.01%	0.44%	-23	-6	7.6%
Transportation	118	-6	-7	16	4.92%	4.21%	4.21%	0.78%	-5	2	0.8%

Source: Bloomberg, MUFG U.S. Macro Strategy

### **IG Issuance Update:**

- 2023 started off very strongly with new IG issuance through Jan. 20 reaching \$110bn, not far from the \$142bn for the entire month of January last year and resuming a more normal pace after the paltry \$7.3bn issued in December, the weakest December in 15 years. We believe this strong issuance is partly due to the market rally early in the month and companies wanting to issue before fourth quarter earnings and the next Fed meeting on February 1.
- Markets have been able to absorb supply very well thus far and selling against the calendar has been relatively muted given the large amount.
- Total IG issuance in 2022 totalled \$1.19 trillion, which is 20% below 2021, 20% below the 3-year average, and 14% below the original estimate of \$1.4 trillion from a year ago, largely due to the Fed's aggressive rate increases that dampened issuers' incentive for discretionary issuance.
- For 2023, we estimate IG issuance of about \$1.3 trillion, which is 9% above 2022 and 12% below the 3-year average of \$1.478 trillion. The reason for growth in issuance this year is primarily due to refinancing of debt maturities as well as the potential for increased issuance in the second half of 2023 if the Fed begins to pivot on its rate policy.

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## FX Outlook

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The US dollar on a DXY basis has dropped by a further 4% or so since our last Global Markets Monthly (15<sup>th</sup> Nov 2022) and at that point had weakened 5% over the previous month – so the turnaround for the US dollar is now more compelling. As we stated in November, we believe the cycle high is in place for the US dollar and we expect the dollar to be weaker by year-end. However, we did not expect dollar weakness to have been as sustained as it is and indeed assumed some recovery in Q1 2023 before a clearer sustained trend of dollar weakness emerged. A large rebound for the US dollar now seems less likely. China abandoned its covid-zero policies much more quickly than expected and the drop in natural gas prices in Europe has been much greater than expected. The OIS market now is priced showing the ECB is expected to be the most active in hiking rates over the coming six months. Balance sheet shrinkage on top and yields have shifted much more notably in favour of EUR/USD. While the BoJ maintained its YCC policy in January, expectations of a shift in policy later this year will limit JPY downside as well. Still, a linear straight-line depreciation of the US dollar is unlikely and high global rates will likely mean risk deteriorates and this will result in periods of US dollar rebound.

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## BASE CASE EXPECTATIONS, JPY, EUR & CNY

### USD/JPY – NEUTRAL BIAS

- **Range : 127.00-134.00**

We have narrowed the range for the month ahead more considerably from 12 big figures in November to 7 big figures to reflect our belief that we may have entered a short-term equilibrium zone given the volatility that coincided with the YCC policy change in December and the refusal of the BoJ to consider further changes to YCC at its meeting in January. We suspect the actions taken should result in reduced speculation for a period of time that means reduce volatility. In addition, 10-year US Treasury bond yields are unlikely to surge from here with the Fed more likely than not to switch back to more normal sized 25bp rate increases over the coming two meetings in February and March. We believe the Fed will then pause given slowing growth and continued declines in inflation.

Firstly, it is important to stress that the BoJ speculation has played a secondary role when the overall drop of 20 big figures in USD/JPY is considered. The global fundamental backdrop and the intervention by the Japanese authorities combined to give a powerful impetus for a correction lower. A turn in US inflation to the downside, the approach of the expected end to monetary tightening outside of Japan and the collapse in energy prices are all JPY-supportive developments. The reopening of China much more quickly than expected will also help to improve Japan's trade position both on the export of goods and on the services side through increased China tourists after years of limited travel. The terms of trade shock through the rise in energy prices is very unlikely to be repeated in 2023.

But the BoJ did play a larger role in influencing prices more recently. Indeed, our own internal short-term valuation model indicated when USD/JPY was trading at the recent lows around 127.00-128.00 that there was a 6% divergence to the downside for spot relative to our short-term fair-value estimate. When we alter the input of for JGB yields in the model to show an end to YCC with the 10-year put at say 0.90%-1.00%, the divergence between spot and the model estimate closes considerably. So it is clear from this that market participants were using USD/JPY as a proxy for speculating on an end to YCC. Governor Kuroda has now made a strong case for the continuation of YCC and with his term ending on 8<sup>th</sup> April, we see 28<sup>th</sup> April as the very earliest for any changes to policy under a new Governor. But even then seems too early with a new Governor likely to take some time to conduct a policy assessment and to conduct internal discussions within the BoJ before making any changes.

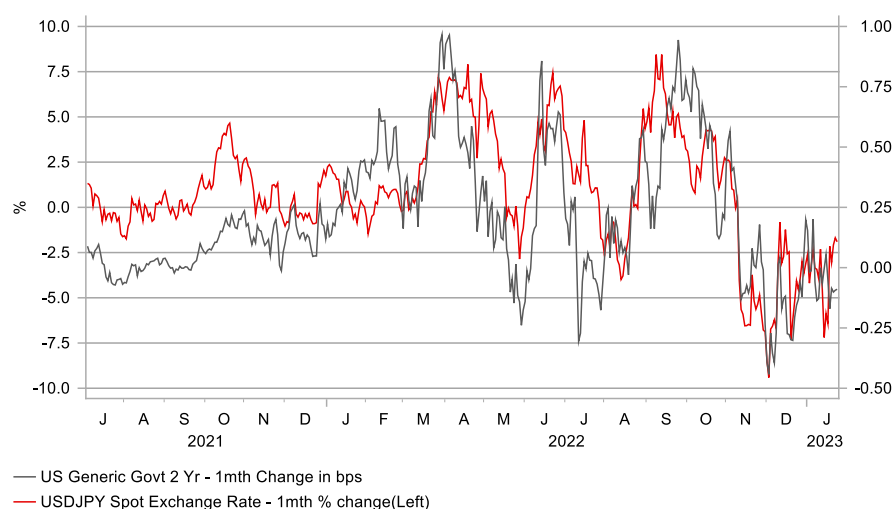
The step taken by the BoJ at the January policy meeting to extend loans to commercial banks under pooled collateral for longer tenors appears to have helped eased the speculation in the market. The change allows commercial banks to fund swap positions cheaply and take advantage of the 10yr swap rate. This flow will help tighten the 10yr swap rate to the JGB yield equivalent and ease the upward pressure on the JGB yield.

We should not forget fundamentals in BoJ deliberations as well. The upcoming 'Shunto' wage negotiation period will be important for BoJ policy deliberations. The 3mth average of YoY contractual cash earnings in Japan currently stands at 1.7%, the highest since 1997. The Trimmed Mean CPI YoY rate stands at a record 3.1% and if wages do continue to pick up, there will be more of a fundamental basis for a change in YCC later this year. The BoJ may also determine that altering or abandoning the policy when global yields are under downward pressure as inflation falls is a more opportune time for a policy change.

All of this suggests YCC policy speculation may pick up again. The primary candidates to take over from Governor Kuroda (Amamiya, Nakaso & Yamaguchi) are all expected to move away from 'Abenomics' (to differing degrees) which means speculation could well pick-up later in Q2. For now however, after the large 20-big figure move in just three months, we expect USD/JPY to trade in a tighter range than what we have experienced in recent months. PM Kishida stated over the weekend that a new candidate would be chosen to be put forward to the Diet in February but this could well be after our scheduled next GMM publication release (15<sup>th</sup> Feb).

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### THE BIG MOVE IN RATES AND FX LIKELY BEHIND US NOW



Source: Bloomberg, Macrobond, MUFG GMR

- **Range: 1.0400-1.1300**

We are sticking to our bullish bias for the EUR/USD although are more wary now that the balance of risks is no longer as favourable for further upside following strong gains in recent months. The pair has already reversed around three-quarters of the sell-off triggered by the start of the Ukraine conflict between late February and September of last year. Prior to the start of the conflict, EUR/USD was trading between 1.1200 and 1.1500 throughout most of last February.

The recent rebound for EUR/USD has been driven by a reversal of three important fundamental drivers that were responsible for USD strength last year. Firstly, fears over a sharper and more prolonged economic slowdown for euro-zone economies have not materialized over the winter period. The incoming data flow from the euro-zone has been surprising strongly to the upside since late last year and is on the strongest run relative to more downbeat expectations since the middle of 2021. The latest positive economic surprise was the euro-zone PMI surveys for January that revealed business confidence rose back to levels more consistent with weak growth. The euro-zone economies appear to be proving more resilient than feared helped by the warmer winter weather. It has prompted European asset markets to scale back recession risks for the euro-zone which has helped to provide more cyclical support for the EUR. Downside risks to growth in the euro-zone will diminish further if the price of natural gas remains at lower levels in the year ahead. Building optimism over a stronger rebound for China's economy later this year as it reopens more fully following the rapid shift away from zero-COVID policies is also encouraging more optimism over the outlook for euro-zone economies and the EUR.

At the same time the EUR is benefitting from the narrowing monetary policy divergence between the ECB and Fed. We expect the ECB to deliver another 50bps hike at next week's policy meeting and continue to signal that at least one more larger 50bps hike is likely at the March policy meeting. We only expect a slowdown in the pace of hikes back to 25bps in Q2 when there is more concrete evidence that inflation pressures are easing. It stands in contrast to our expectation for the Fed to further slow the pace of rate hikes by delivering a 25bps hike at next week's FOMC meeting. We then expect the Fed to pause rate hikes in Q2 but are not expecting the Fed to signal yet that they will pause hikes soon. The Fed's still relatively hawkish plan for further hikes beyond next week could help to dampen the USD selling pressure for now.

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### PRICING IN A BETTER CYCLICAL OUTLOOK FOR EURO-ZONE ECONOMIES



Source: Bloomberg, Macrobond & MUFG GMR

Range: **6.7000–6.9000**

The CNY has strengthened during the past month from around the 7.0000-level to a recent low of 6.6910, amid the continued optimism over the potential positive development of the Chinese economy and markets due to the abandonment of key zero-Covid policies in early December. Additionally, China's National Health Commission said on 26<sup>th</sup> December that the quarantine requirement for international arrivals will be cancelled from 8<sup>th</sup> January although a negative PCR result within 48 hours before departure is still required. On the same day, China renamed the official name for Covid-19 from "novel coronavirus pneumonia" to "novel coronavirus infection" and downgraded the preventive and control measures of the disease to the less strict Category B from the top-level Category A.

The recent strengthening of the CNY appears a bit detached from the weak economic fundamentals and data releases from China at the turn of the year. China NBS released a 47 for manufacturing PMI and a 41.6 for non-manufacturing PMI for December 2022, with manufacturing and non-manufacturing PMIs decreasing by 1ppt and 5.1ppts respectively. Data for China's macro indicators in December released on 17<sup>th</sup> January continued to indicate the stress faced by Chinese economy on both demand and supply sides: although year-over-year growths of industrial production, retail sales, fixed assets investment, property investment all surprised the market to the upside, these growths still further declined from the prior month's value except for retail sales growth. Mildly positive month-over-month expansion was seen in industrial production and fixed assets investment. Although retail sales growth improved to -1.8%yoy in December from November's -5.9%yoy, the month-over-month change still showed a 0.14% decline in December. Both property investment and floor space sold in year-to-date term contracted by larger degrees of 10%yoy and 26.7% respectively in December. In addition, China's exports in December fell for the third month in a row and grew at its worst pace since February 2020. In the fourth quarter of last year, GDP growth slowed to 2.9%yoy from 3.9%yoy in the prior quarter, with a zero quarter-over-quarter growth implied. For the full year of 2022, China's GDP expanded 3.0%yoy, missing the official target of "around 5.5%" and was the worst growth since 1976 when excluding the 2.2%yoy expansion in 2020.

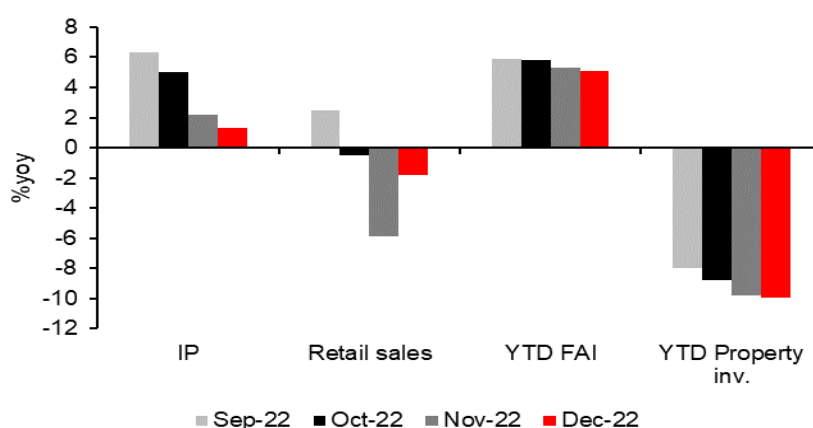
With the releases of the government work reports, the 2023 GDP growth targets of 31 provinces (districts, municipalities, excluding Hong Kong, Macao and Taiwan) across the country have all been released. The values of 31 provinces' 2023 growth targets range from 4% to 9.5%. Among them, the highest is Hainan Province (about 9.5%), the lowest is about 4%, and 2023 growth targets of most other provinces are mostly concentrated at the range between 5% to 6.5%, mostly "6%", and among which 12 provinces set the growth targets at 6% or above or around 6%. Meanwhile, the government continued to roll out measures to support the real estate sector, on 5th January, PBOC and China Banking and Insurance Regulatory Commission jointly issued a notice deciding to establish a dynamic mechanism linking the mortgage rates of the first-home purchase to new property prices. Cities are allowed to periodically maintain, reduce or remove the floor of mortgage rates for first-time home buyers if the new property prices have declined for three consecutive months in both month-on-month and year-on-year terms. We expect the sector to bottom out in Q2 and eventually deliver positive sales and investment growth in 2023.

With China's change in Covid-19 policy and reopening, the Chinese economy is set to accelerate through this year. However, the infection and gradual build-up in confidence towards the consumption and investment would only mean a gradual improvement in economic activities in near term, rather than a robust release of pent-up demand of consumption seen in western economies when they reopened. Economic momentum is likely to show more noticeable growth momentum in Q2/Q3, and recover to a more "normal growth" at Q4 with around 6%yoy GDP growth.

High frequency transportation data shed similar light about the change in momentum and level as well. Passenger volume rapidly scaled up following China's dismantling of most Covid curbs, with China's 40-day Spring Festival travel rush from 7<sup>th</sup> January to 15<sup>th</sup> February expected to reach about 2.095 billion passenger trips, up 99.5% from last year but still about 70.3% of the pre-epidemic level in 2019, according to China's Ministry of Transport. Having said that, it has brought about concerns about Covid-19 outbreaks spreading to rural areas. On 18<sup>th</sup> January, President Xi Jinping expressed concern that the Covid-19 outbreaks could spread to rural areas, where medical services and resources are insufficient, after the country adjusted its Covid-19 response measures, calling on frontline medical workers to increase self-protective measures during the current wave of infections.

While for the medium-term (by the end of this year), we expect a stronger stock market and further strengthening of CNY against the US dollar, due to the (better) growth and continued revaluation on China assets, in near term, volatility may remain, as recent positive sentiment could have over-run, and economic momentum is unlikely to pick-up materially so soon.

### CHINA'S ECONOMIC ACTIVITY REMAINED WEAK IN DECEMBER 2022



Source: CEIC, MUFG GMR

### KEY RISK FACTORS IN THE MONTH AHEAD

- We have narrowed the range for USD/JPY in the month ahead and assume the big move over the last three months will result in some narrower range trading. An announcement that Hirohide Yamaguchi would be put forward to the Diet could spark a bigger FX move as abrupt YCC changes would be brought forward by the markets. That would imply a sharper move to the downside than expected. To the upside, a 50bp hike by the Fed and a more hawkish FOMC communication would see a larger than expected move to the upside.
- There are a number of key downside risks to our bullish EUR bias in the month ahead including: i) the ECB signals it is more open to slowing the pace of hike at the March policy meeting ii) the recent resilience of the euro-zone economies proves to be misleading/short-lived and growth slows sharply with more of lag than expected, and iii) geopolitical tensions between the West and Russia escalate further after tanks are sent to support Ukraine which alongside a pick-up in demand from China demand lifts European energy prices.
- The ongoing China Spring Festival travel rush is shifting the focus of Covid outbreaks from cities to rural areas, where medical facilities are relatively poor, and they are with high concentration of the elderly. After three-years of Dynamic Zero Covid-19 policy, the challenge is on building up the sentiment for demand including consumption and investment.



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## European Credit

Credit markets have had a strong start of the year, with overall yield levels now much more attractive compared to early 2022. The numerous concerns that have accompanied the market in 2022 seem now less daunting and the main focus is now on recession risks in Europe and beyond. The recent inflation trends have been encouraging and even recession fears have come down, also helped by the reopening of China. The market has priced in further rate hikes but feels now more comfortable with the rates outlook. The situation in Ukraine doesn't show signs of appeasement and remains a cause of uncertainty, but the market has grown used to it.

As a result, synthetic indices recovered materially over recent weeks with XO tightening another 58bps year to date to 420bps (from a wide of 672bps in September 22). Pre-invasion of Ukraine XO was in the 320 area. Main is also materially tighter at 80bps, while by historic standards these look too elevated, implying multiple defaults, yet they remain an easy hedge as investors tackle volatility deriving from economic performances or geopolitical risk.

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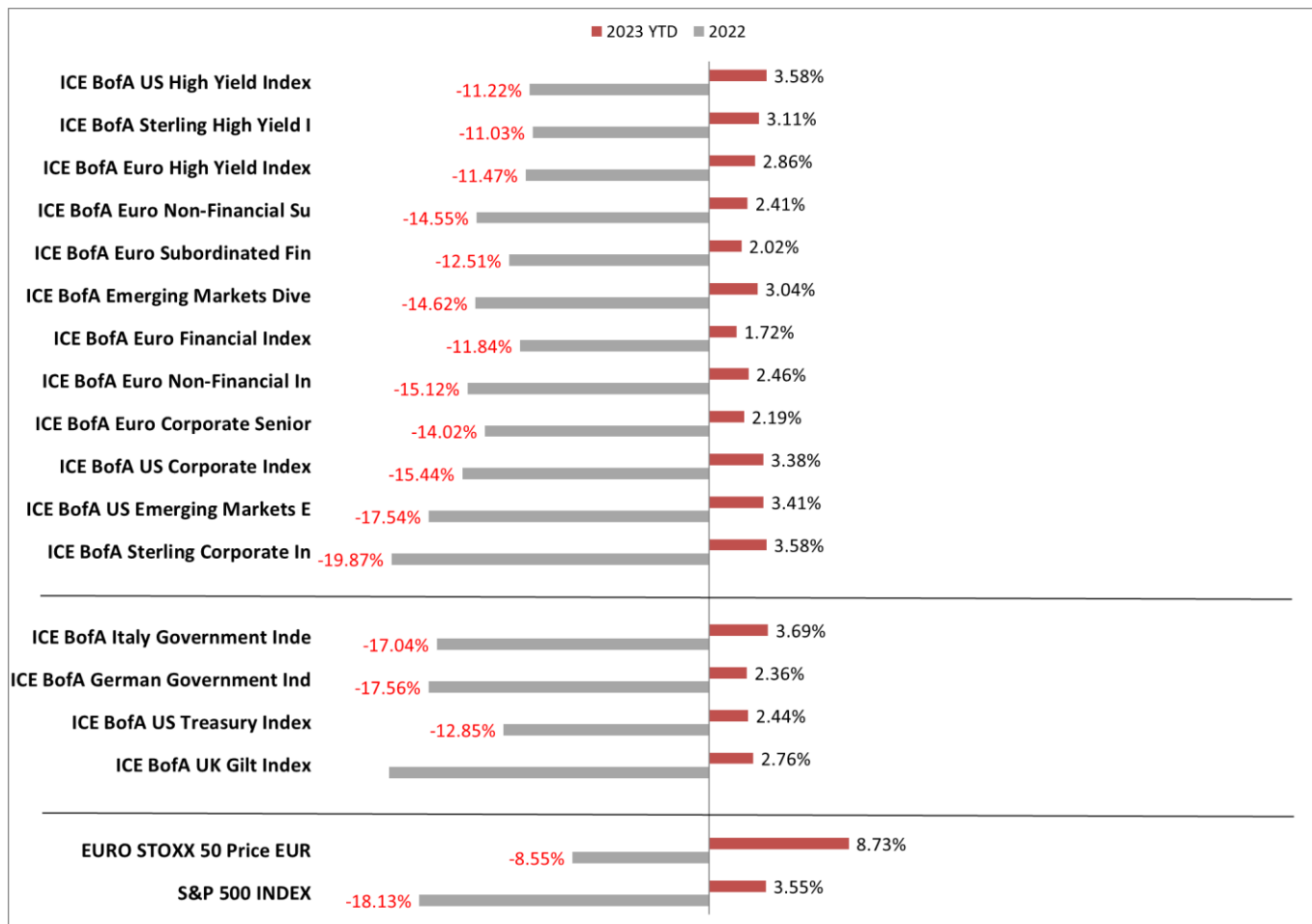
### 2023 KICKS OFF MUCH MORE POSITIVELY

#### **More carry but less upside compared to October – November 2022**

Rates continued to rise as central banks tighten monetary policy, the 10 Bund yield is now at 2.1%, down from 2.5% at the start of the year. The UST 10 year is now 3.43%, also close to recent highs, as the FED raised discount rates to 4.5% from 0.25% in less than 12 months and continued a hawkish rhetoric.

Market and rates volatility have subsided and have allowed issue volumes to pick up massively to a record amount for credit in January 23, in excess of EUR240bn equivalent. Credit funds have benefitted from strong positive returns in recent months and the risk of outflows has now come down. Overall technical seem to be decently supported but the market remains vulnerable to periodic bouts of risk aversion, depending on economics, inflation, Central Bank policies or geopolitics. From here higher carries should continue supporting returns even if spreads might see more lateral moves directionally. However, if we are approaching a worse than expected recession the lower rated product may not be the place to remain as defaults will eventually tick up. We prefer to keep the carry in safer haven, less volatile and fundamentally stronger names, than looking for higher carry in higher risk product at the moment.

YTD 2023 TOTAL RETURNS BY ASSET CLASS



Source: Bloomberg, ICE BofAML, MUFG

EUROPEAN BANKS

**In the bank credit space we have a constructive approach based on resilient P&L expectations and robust balance sheets against a less difficult backdrop than previously feared.**

**In our view spreads will remain to some extent vulnerable to waves of new issuance throughout the year. We view, nevertheless, the current spreads still as offering decent value for investors, especially through the primary market.**

Versus last time we wrote the fears for a European recession have reduced and the inflation data have shown some encouraging signs of improvement. Geopolitical risk hasn't very much changed as the war in Ukraine continues its grind and China maintains an assertive stance towards Taiwan. The bigger difference is probably the re-opening of China to the rest of the world, which is supportive for the economic picture globally, including in Europe.

Since European banks have reported 3Q22 results and Central Banks have continued their monetary restrictive policies, via rate hikes and/or accelerated tapering whilst closely watching the inflation numbers. This is supportive for banks' Net Interest Margin expansion, which in turn, is good for top line growth.

Since the 3Q22 results bank managements have generally maintained a quite constructive rhetoric. The inflation pressures are still building on households and on companies but the more acute fears for a winter energy crisis have now subsided. The low unemployment figures across Europe and UK should shield the residential mortgages, for now, from rising borrowing costs but we expect erosion to become

more visible on consumer financing and unsecured personal lending books, including credit cards. SME's might have to reduce production or even temporarily shut down on too high energy costs. This may feed through some asset class deterioration as well. FY22 results season should see bank managements giving new guidance on FY23 costs of risk.

### **Expect a decent FY22 reporting season for European banks**

The key focus points in this reporting season remain:

- 1) The positive impact from the climbing rates on margins should continue but the pace of margin expansion may prove less strong than in 3Q22 as the deposits repricing should now play a more prominent role.
- 2) Operating costs and the impact on the cost lines from inflation. We expect this to remain reasonable.
- 3) Cost of risk, as banks have to continue setting provisions aside with the view of a cyclical downturn and the expected weakness in the consumer/credit cards and some more vulnerable sectors such as commercial real estate.
- 4) Capital should remain strong across the board as banks have accumulated capital during the covid lockdowns; however, the RWA inflation and the elimination of the capital relief actions conceded by the supervisors, along with other market related adverse impacts on capital, have shown in banks reducing some of their excess capital buffers.

Altogether banks are in a solid position to face the upcoming economic downturn, which is quite different from past downturns. We expect the strong topline to be offsetting to a good extent higher operating costs and cost of risk.

From a fundamental perspective, we believe that a cyclical down turn should be manageable for the banks, as was also underscored by the resilient outcome of the 2021 EBA/ECB European Banks stress test.

### **Market kicked 2023 off strongly, less upside now but bank spreads/yield look still attractive**

The name of the game has changed in 2023, after the big re-adjustments seen to spreads and yields in 2022. We are now in a higher yielding world which allows for better total returns, as seen in the bar chart here above, but also for tighter spreads. We don't expect to return to the tightness seen during the years of maximum quantitative easing but, with our constructive view on banks' fundamentals, we believe that that bank credit can be seen as a relatively safe place to money at work in 2023.

There may be periodic bouts of more general risk aversion (driven by fluctuations in fears of recession, inflation, geopolitics...) in the markets but we would think that these represent potential entry points for investors in the case of any visible bank spread widening. Some periodic widening can also be driven by periods of higher issuance but overall these should be relatively short lived. The technical drivers, such as TLTRO repayments, or MREL issuance are well known and shouldn't lead to significant downside surprises.

The total returns chart shows strong year to date returns across asset classes. for European banks across equity and the various debt subordinations. Senior and subordinated financials have underperformed the other sectors in credit and leave them looking relatively attractive versus corporates.

Despite the record amounts of primary the spreads have held up well as shown in the charts below. Year to date banks issued already above EUR80bn in new deals across subordinations and currencies. According to our calculations this represents around 25% of the bonds coming to a first call or final maturity in 2023.

The massive funding support from the Central Banks and the ECB in particular through the Long Term Refinancing Operations (TLTRO III) is coming to an end over the coming 2 years, but the bulk runs off, or will be repaid early in 2023 we expect. TLTRO III peaked at EUR2.2trn but is now already down to EUR1.32trn. TLTRO III had 10 operations done every 3 months since 14 August 2019 at which point the outstanding was close to EUR700bn, only when the pandemic hit, did the amounts shoot up to over EUR2.2trn.

First maturities of TLTRO III were end Sep 2022 (followed by redemptions quarterly) but more significant redemptions will only start in 2023, we expect the ECB to smoothen this out to avoid cliff edges. However we expect that if left to its own the dispersion between core and periphery is likely to further widen.

### **Valuation, more attractive but we remain cautious for the rest of the year**

We believe the market has grown more comfortable with the current interest rates and that much of the expected hikes are now priced in. This would make the longer end (say 8 years plus) look attractive but the credit curves are quite flat beyond 5 years. This leaves modest relative value on the table versus the 5-6 year part of the curve in EUR. Both EUR and USD markets have performed well and have been orderly in recent months. We expect this to continue.

### **EUR beta not really compressing nor expanding much**

In terms of compressions the charts below the the banks bail-in senior versus subordinated multiple has widened somewhat to 1.7X returning to a longer term average. The absolute spread differential has seen minor changes in recent weeks and is still hovering in the 65bp-70bps area. We expect this to remain relatively stable as we expect overall spreads to have a sideways, range bound, direction over the coming months.

In terms of senior non bail in versus senior bail there has been relative stability as well with a multiple pretty much stable in the 1.4X area and 40bps differential in absolute terms. This was 50bps at end October but the market has rallied significantly since then. We expect this to remain stable over the foreseeable future. The mix of senior bail in and non-bail in issuance should get now more at a cruising level given that most banks have fulfilled there MREL/TLAC requirements and only a few banks still need some additional MREL issuance.

### **USD and EUR markets continue to behave differently**

The charts below show that the yankee banks spreads behave somewhat differently from EUR. Part of that has to do that the yankee indeces contain less peripheral or higher beta names than the EUR equivalent indeces. In USD the spread differential between sub and bail-in senior is currently 47bp This means that there has been actual compression of sub versus senior as shown by the multiple, down to 1.3X currently versus 1.2X at end October. Compared to EUR the USD T2 space still looks quite rich.

The overall higher yield levels have come down somewhat in recent months as a combination of lower underlying yields and some spread compression. Senior tightened to 171bp in USD from 209bps at end October recent wided. In recent weeks the spreads moves have been less pronounced and more lateral. At current yield levels we think the space is still attractive, but clearly less than one or two months back.

We expect perhaps more stable spread levels over coming months (albeit still volatile). Investors may be nervous to put money at work in the case of outflows and the general lower support from Central banks, amidst the war in Ukraine but, we repeat that we see any bouts of more visible widening of bank spreads as potential entry points. In USD the most attractive point in the curve is in the 2-3 years space but also low cash prices in the 8-10 years part of the curve still look attractive.

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