Global Markets Monthly

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20 April 2023

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Euro Area Macro

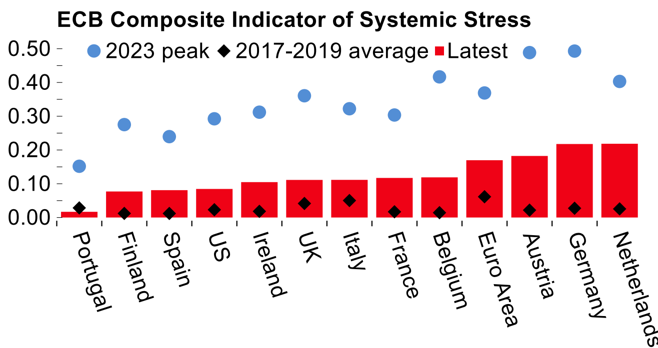
Banking sector fears have mostly subsided in Europe after a period of intense market scrutiny, but the macro repercussions could prove more persistent. Credit conditions were already looking tight even at the end of last year and there is a clear risk of a credit crunch weighing on economic activity over coming quarters. This could offset stronger economic momentum seen recently in the euro area and leave growth relatively muted through 2023.

BANKING SECTOR FEARS HAVE MOSTLY SUBSIDED

The European economy emerged from the winter on a much better footing than expected after navigating the energy crisis (see here), but any respite was short-lived as market attention shifted quickly to stress in the financial sector. The collapse of SVB in the US in early March and the sudden acquisition of Credit Suisse by UBS stoked concerns about a broader banking crisis after the sharp rise in interest rates.

But as time has passed after the initial period of extreme market scrutiny it seems more likely that issues at Credit Suisse and SVB may have been isolated incidents rather than an indication of wider, systemic issues in the banking sector. Financial markets have clearly calmed over the last few weeks. The EuroStoxx Banks index, while not back to its early March levels, is still over 10% up YTD. Chart 1 shows how the ECB's daily systemic stress indicator has fallen back sharply (but does remain above post-sovereign debt crisis/pre-pandemic averages).

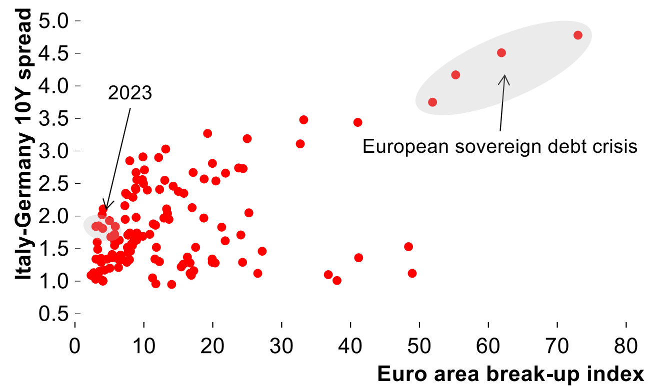
CHART 1: SYSTEMIC STRESS INDICATORS SHOW NO REASON TO PANIC



Note: The CISS index is a daily indicator published by the ECB designed to show stress in the financial system. It is created from 15 inidividual series, aggregated into 5 market-specific subindices. It is designed to place more weight on situations in which stress is occuring in several market segments at the same time.

Source: ECB, Macrobond, MUFG Bank ERO

CHART 2: FEW CONCERNS CURRENTLY ABOUT A REPEAT OF THE EURO AREA SOVEREIGN DEBT CRISIS



Note: The Sentix Euro Break-up Index shows the percentage of investors surveyed who expect at least one country to leave the euro area within the next 12 months.

Source: Sentix, Macrobond, MUFG Bank ERO

On paper, the numbers are reassuring: European banks' liquidity buffers look healthier than in the past, and balance sheets seem less toxic with a fall in non-performing loan ratios since the sovereign debt crisis years. European banks are also now subject to stricter regulation with the ECB granted a supervisory role since 2013. And, taking a step back, the risk of any euro area member country leaving the single currency is not a current issue (Chart 2).

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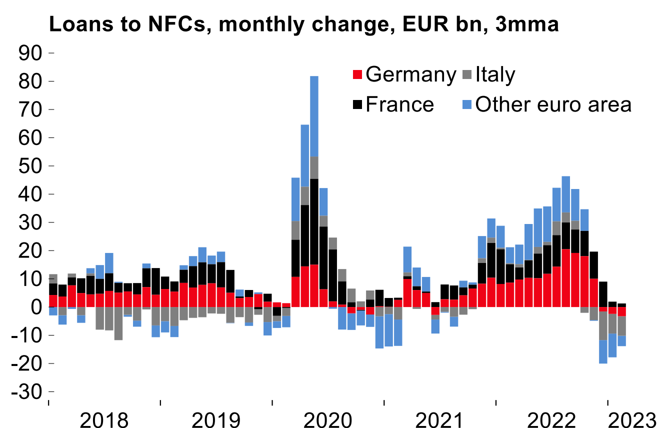
So, while we're not ready to say that a crisis has been averted, it's certainly encouraging that European banks have so far withstood intense investor examination after the takeover of Credit Suisse. Of course, recent events have made it clear that market conditions can change quickly and concerns about the banking sector will not vanish entirely. There may well be more areas of concern yet to emerge following the shift to a higher interest rate environment after years of rates at the lower bound. For instance, we note that there are now some signs that the European housing market could be responding to higher borrowing costs, with the EU house price index showing the first quarterly decline since 2015 in Q4 2022.

TIGHTER CREDIT CONDITIONS WILL BE A HEADWIND FOR GROWTH

As it stands, our main concern is the risk of a credit crunch weighing on economic activity. The data suggest this is already happening to an extent: there has been a clear slowdown in credit in recent months (Chart 3), and European banks were tightening credit standards even before recent market unrest (Chart 4).

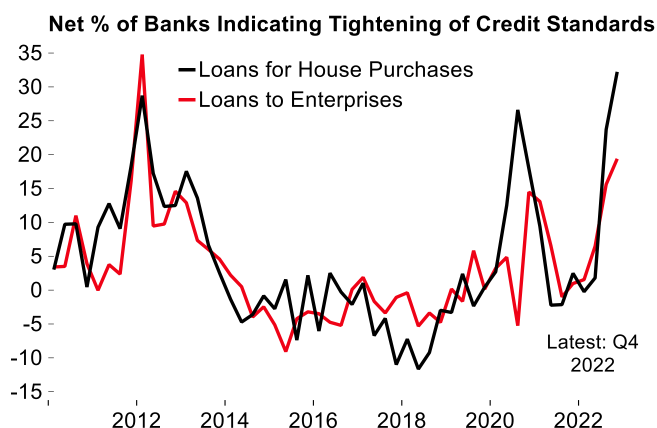
It seems likely that credit conditions will have worsened in Q1, and this could yet be amplified further by a weaker US economy (where the recession risk has probably risen recently). The European economy is more bank-orientated – bank lending to the private sector stands at about 90% in the euro area vs 50% in the US – and tighter credit conditions are set to be a headwind for growth over coming quarters.

CHART 3: THERE HAS BEEN A CLEAR SLOWDOWN IN CREDIT IN RECENT MONTHS



Source: ECB, MUFG Bank ERO

CHART 4: TIGHTER CREDIT CONDITIONS – EVEN BEFORE RECENT MARKET UNREST



Source: ECB, MUFG Bank ERO

However, there's also encouragement to be found in survey data, which has been fairly resilient to the market situation in March. Euro area PMIs are now clearly in expansion territory. In terms of hard data, industrial production increased by 1.5% M/M in February, which, coming on the back of a 1.0% increase in January, bodes well for Q1 GDP. After flat growth in Q4 last year, it now seems that the euro area economy could avoid the widely-expected technical recession in H1 2023.

Part of reason for this is that the manufacturing sector has benefitted from both continued improvements in global supply chains and lower wholesale energy costs. These tailwinds for industry will fade through the year, however. Meanwhile, euro area retail sales again disappointed in February (-0.8% M/M). It's still a tough consumer environment (see here), even as headline inflation falls, and European governments will taper cost-of-living support packages through the year.

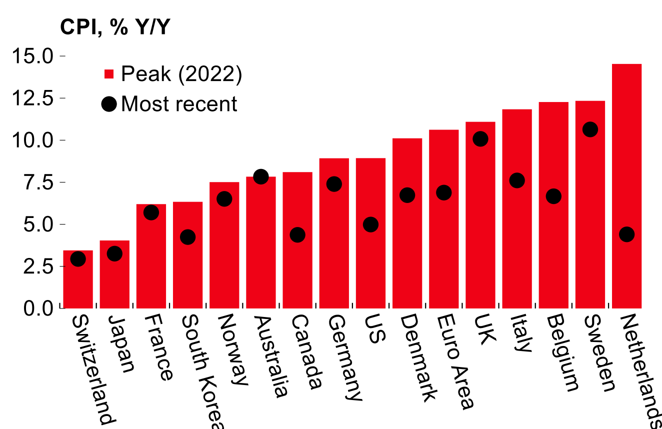
Our current view is that tighter credit conditions will offset the stronger-than-expected growth momentum at the start of the year, and we continue to expect annual average euro area GDP growth of around 0.5% in 2023. But a plausible downside scenario is a more severe credit crunch which pushes the economy into recession in H2.

CENTRAL BANKS ATTEMPT TO HOLD A STEADY COURSE

Major central banks all held policy meetings against the background of market unrest in March. The general from monetary policymakers was that they are willing to look past the episode of market turbulence and will attempt to hold a steady course. The ECB hiked by 50bp, as it had previously signalled it would. The BoE went for a 25bp increase, the smallest move since June last year, but again it was broadly consistent with the signals from the previous policy meeting in February.

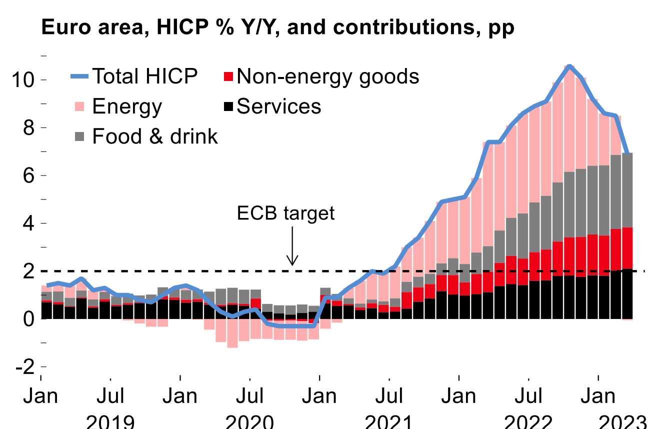
Both central banks have some more work to do. In the UK, after 11 rate hikes in a row, the indications are that the BoE is getting close to the peak rate in this cycle and will now take a meeting-by-meeting approach, with flexibility to respond to incoming data. Indeed, releases this week will probably now push the BoE to at least one more hike. Inflation is proving stubbornly persistent in the UK (Chart 5) with the headline rate in double-digits now since September, and there were few signs of cooling wage growth in the jobs figures. Further ahead we do expect headline inflation to fall fairly quickly (as we're already seeing elsewhere in Europe) once as energy base effects come into play from April. In that case, clear evidence of lower pay growth could be reason enough for the BoE to press pause on rate hikes after the May meeting.

CHART 5: HEADLINE INFLATION IN THE UK IS STILL CLOSE TO THE 2022 PEAK



Source: Macrobond, National sources, MUFG Bank ERO

CHART 6: UNDERLYING EURO AREA INFLATION IS PROVING PERSISTENT



Source: Eurostat, MUFG Bank ERO

Meanwhile, the ECB was later to start tightening policy and the indications are that it will continue to raise rates. The latest ECB HICP projections point to above-target inflation until mid-2025 and the message from recent speeches seems crystal clear: the job is not yet done. Euro area headline inflation is falling quickly now (Chart 6) but the core rate reached a new record high of 5.7% in March and there is no indication that it is set to trend downwards in coming months. Markets are pricing in a little over 75bp of further rate hikes by year-end.

However, as noted above, there was evidence of tighter credit conditions even in Q4 2022 in the ECB's Bank Lending Survey (BLS), and a further deterioration would strengthen dovish arguments. It's worth noting that the next quarterly BLS is due on 2 May, two days before the next ECB monetary policy meeting, and could be an important factor around the decision.

And if market conditions were to deteriorate again then the aim for policymakers will be to keep decisions on financial stability separate from those of price stability. The BoE's response to the LDI market turmoil last year demonstrated that this is possible when it intervened in bond markets while also maintaining its quantitative tightening target.

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US Fixed Income: Nearing a macro inflection point

Macro View: In our view, the next four months into the August reporting period will be super critical for assessing the outlook for the US economy. We believe that the combination of the bank induced credit crunch which is now amplifying both QT and the "long and variable lags" of the supersized hikes, all this is working double-time at slowing the economy.

Our probabilities remain high that when the NBER looks back at 2023, its likely that they will surmise that the US economy has either fallen into a recession by late Q2 or sometime over the summer towards late Q3. The window for recession is that close in our view. However, it's going to take time to fully underwrite this view, and again, Q2 should start this process.

Since our last update the US jobs data has shown further deceleration and the weekly unemployment claims data has had a notably jump into the 240k region recently. This shift in the direction of claims was one of the criteria we were looking for to get further behind our recession call in 2023. Meanwhile inflation data is entering the peak of last year's high prints which will result in the base-effects furthering the disinflationary trends.

Fed Policy: The one thing that has become clear in our stance on Fed policy, if the market is pricing in hikes, and Fed speakers do not push back on market pricing, as we head into a rate decision, so long as rate hike probabilities are in the 65-100% zone – they will hike. At current time of writing, the May 3rd FOMC probability of 25bp hike is sitting at 88%. So long as nothing derails these expectations, the Fed will hike in May again.

Yet we are entering the period where the data (a quick CPI slide in Q2/Q3 plus job losses will start to stack up in our view) will give the Fed plenty reasons to pause soon enough. Either way we are relatively indifferent if they hike once again in May. In our view the cycle is coming to an end.

The Fed will at some point need to defend why they will keep rates "higher for longer" and that will likely be a harder message to convey versus the quick successions of hikes over the past year. Once you are off a program of hiking (and just waiting around to assess the damage that all of this tightening is having on the real economy) the burden to stay on hold grow. And in this world things tend to happen much faster. As we wait for a specific catalyst, the first cut can happen in September or later in the year.

Rates View: All segments of the yield curve have been trading deeply inverted to the Fed Funds (FF) overnight target rate. We do not see that changing anytime soon, in all likelihood, the inversion to FF will grow after the next rate decision. Yet the bond market remains sceptical of the Fed's staying power at such high rates, so do we. Meanwhile the backend of the curve is coming up against some moving averages that should provide support. The 2yr could get dragged up another 10-15bps but even that tenor will probably start to stall from its recent rate rise. We advocate buying on dips and start to look at curve steepeners led by the front-end.

US MACRO: POST FED MEETING FOCUS ON THE DEBT CEILING

The first fourth months of the year has been a tug-of-war between a soft landing, where some economists even went as far as suggesting a no landing was in the works (i.e. that US growth could ramp up again) versus a small set of forecasters still calling for contraction ahead (where the list kept dwindling at the start of the year when the no-landers were convincing people otherwise). We were part of that small minority that stuck with our view that the stronger economic activity in early Q1 was seasonal factors, weather-related and unsustainable given the path the US has been set on.

Our base-case has remained recession since mid-2022 because the post CV19 reopening activity was similar to a post-war boom/bust period where recession surfaces sooner as the Fed tightens quickly to crush inflation and aggregate demand and then eventually jobs. Our recession odds remain high given the long and variable lags of rate hikes, ongoing QT, 2022's strong USD impact, and now weaker banking.

We are now at the point where the last remaining piece in the puzzle, the most lagging of lagging data – the labor markets – will likely start to show more cracks and then eventually outright declines. It will be a process and then happen all at once when we go from positive job growth to eventually flat and perhaps negative NFPs soon enough. Meanwhile the inflation data should continue to improve, especially on a year-on-year basis as we head into the summer months. Overall the next four months will start to feel like we are actually falling in, if not in it already, the recession some of us feared.

It's for this reason we are pretty agonistic if the Fed hikes again (because really, what is the difference between a 5% upper band versus 5.25% at the end of the day). The Fed has been hiking into a slowdown (arguably since Jackson Hole last year) and the more they do so the more likely these last remaining hikes will be the first to get unwound in the second half of the year. The questions we are trying to get our arms around are: a.) how severe will the recession be (as we go through it), b.) how fast is inflation falling to the Fed's target versus c.) how long can the Fed stay on hold ahead.

ELEVATED US 5YR CDS VERSUS THE 10YR RATE MAKING LOWER LOWS

Source: Bloomberg, MUFG US Macro Strategy

And then there is the issue of dealing with the debt ceiling post the FOMC meeting. In our view the markets will quickly shift gears from central bank tightening and start focusing on that quagmire. As you can see in this next chart, the 5-year CDS is back to the early 2010-decade levels (and the 1yr CDS is even more elevated) and the 10yr is trying to stay in the mid-point of the 3-4% range. Watch these two very carefully. We argue, given the political division in the US, the current debt ceiling backdrop is similar, if not worse than 2011. If you recall that was when US politicians took the process down to the wire which resulted in a US credit downgrade. Rates rallied massively. It is too soon to suggest a repeat but this is where our attention is focused on into May.

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FX Outlook

The US dollar on a DXY basis has declined by about 2.5% since the last Global Markets Monthly which is telling given short-term yields in the US, which declined initially have recovered all of those declines as market participants pare back the extent of monetary easing that was priced for the end of this year. 70bps of cuts have been removed by year-end. The fact that the dollar remains weaker over the same period in part reflects the expected continuation of monetary tightening in Europe. Both the ECB and the BoE are expected to hike in May and are priced for additional hikes after that when the FOMC is assumed to have paused. The recovery in yields and increased expectations of rate hikes also is in response to reduced concerns over the banking sector. We continue to expect the US dollar to weaken going forward as the pause by the Fed is followed by weakening economic data that leads to renewed increased expectations of rate cuts by year-end.

BASE CASE EXPECTATIONS, JPY, EUR & CNY

USD/JPY – NEUTRAL BIAS

- **Range : 128.00-138.00**

We held a bearish bias for USD/JPY in our last publication in March and that view has held through most of the period since although just recently we have seen USD/JPY advance above the spot rate from that last publication. The determination of the move over the last month has been very much reflected by Fed rate hike expectations with developments in Japan playing a limited role. Weaker inflation in March and April and a further slowdown in wage data helped fuel expectations of rate cuts by the end of the year. That momentum then turned with the 2yr UST note yield jumping nearly 50bps in the period since early April. Since that turn the investors have pared back expectations of rate cuts by December by 70bps to less than one 25bp rate cut.

While developments in Japan were not as influential in driving USD/JPY recently, that is not to say that will continue. We are approaching a potential key period for the Japan markets with Governor Ueda's first monetary policy meeting on 27th-28th with speculation receding that any change to YCC will be made at that meeting. Bloomberg reported from its sources that the BoJ is "wary" of making changes to YCC at the April meeting. This in part reflected the concerns over financial market conditions following the banking sector turmoil in March. Also the drop in global yields has helped to normalise the Japan yield curve which further reduces the urgency for any change. Governor Ueda also spoke in the Diet this week and again suggested status quo was more likely over the short-term. He stated that joint statement between the government and the BoJ to work together to restore price stability in Japan remained appropriate.

But Governor Ueda did express optimism over the outlook for inflation and wage growth suggesting a continued move toward price stability. He dismissed the global growth concerns stating the BoJ had already incorporated slower global growth and beyond this period of weaker growth, a pick-up was likely. The outlook for wage growth has improved following the confirmation from Rengo, the Japan Trade Union Federation, that the 'shunto' wage negotiations this year resulted in an annual wage

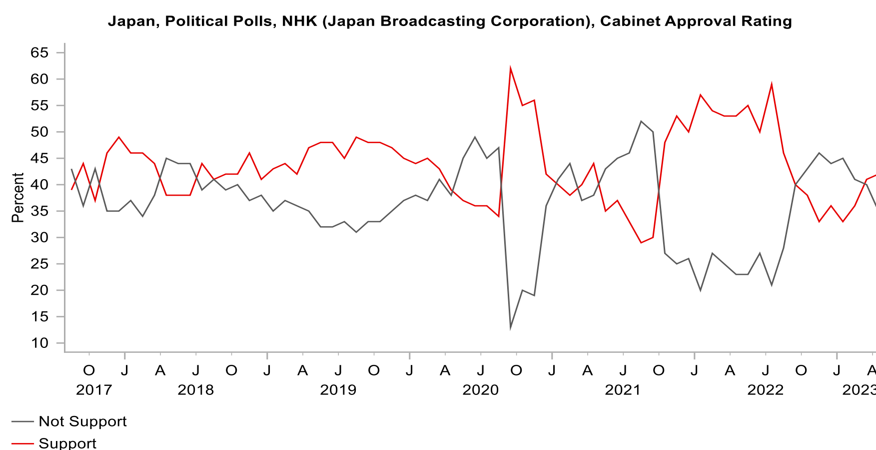
increase before bonuses of 2.3%, up from just 0.5% a year ago and more consistent with wage growth required to reach price stability. The inflation forecasts in the updated projections by the BoJ on 28th April will be important. There are reports the first estimate for 2025 will have inflation at 2.0%, which would likely signal to the market a greater prospect of a change in monetary policy.

While developments suggest we are moving toward a possible change in the YCC framework, political developments may delay any change. PM Kishida's cabinet approval rating has jumped. A TV Asahi poll conducted last weekend saw a 10.2ppt increase in approval to 45.3% while a Yomiuri poll yesterday revealed a 5ppt increase to 47%. There are five bi-elections taking place this Sunday in Japan and if LDP support holds up or certainly increases, PM Kishida may well decide to hold an early election. The current Diet is scheduled to end in June and an announcement before then would mean an election could take place in July. An earlier election is also possible.

That could complicate the timing of any policy changes by the BoJ. The consensus (and our view) has been that an end to YCC or certainly a change would be announced at the meeting on 16th June. That is unlikely if a general election has been called and hence a change in policy would be delayed until the meeting on 28th July when another update of GDP and inflation forecasts will be released. We now lean more toward a delay in YCC change until then on the assumption that PM Kishida announces a snap election at some point before the end of the current Diet session.

The drift higher in yields in the US could propel USD/JPY further over the very short-term. But we are sceptical of that move being sustained and we expect data in the US to continue to slow that allows the FOMC to pause after a hike in May. We also see limited scope for expected rate moves at year-end and into 2024 to move higher. That should mean any further move higher from here corrects lower relatively quickly.

GOVERNMENT SUPPORT NET POSITIVE FOR FIRST TIME SINCE AUG 2022



Source: Bloomberg, Macrobond, MUFG GMR

EUR/USD – BULLISH BIAS

- **Range: 1.0700-1.1400**

The EUR has regained upward momentum against the USD over the past month resulting in the EUR/USD rate hitting a fresh year to date high of 1.1076 on 14th April. The pair is currently threatening to break out to the upside from this year's trading range between 1.0500 and 1.1000. The key catalyst for renewed upward momentum has been the negative fallout from the loss of confidence in US regional banks. Steps

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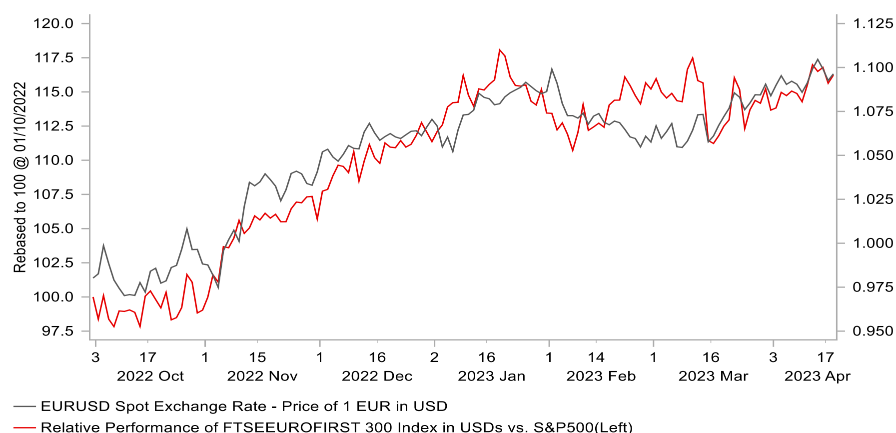
taken by US policymakers including the Fed have helped to prevent a further run on the banking system and collapse of other regional banks alongside Silicon Valley Bank. However, we still believe that the fallout will result in credit conditions tightening sharply providing a headwind for growth in the coming quarters. Regional banks will attempt to pass on higher funding costs to businesses and households, and are likely to be more cautious over extending credit to the economy. The latest NFIB small business survey revealed a sharp drop in the availability of loans. Small and medium-sized businesses are expected to be hit harder by the loss of confidence in regional banks. At the same time, there has been further encouraging economic data releases revealing that US inflation pressures continue to ease. The Cleveland Fed's trimmed mean CPI measure slowed to an annualized rate of 2.8% in March which was the weakest reading since February 2021. The developments give us more confidence that the Fed will soon pause their hiking cycle, and room will then open up later this year to begin cutting rates. At the next FOMC meeting on 3rd May we expect the Fed to deliver one final 25bps hike and to signal more strongly that they are seriously considering pausing their hiking cycle.

On the other hand, the EUR has continued to outperform other G10 currencies. The EUR is benefitting from the easing of last year's negative terms of trade shock. The incoming economic data flow from the euro-zone is continuing to surprise to the upside although not as strongly as at the start of this year. It is now more widely acknowledged that the euro-zone economy is proving more resilient and is expected to avoid falling into recession in the first half of this year. Fears over a sharper growth slowdown have also been eased by the quick action taken by the Swiss authorities to deal with concerns over the health of Credit Suisse that have helped reduce financial stability risks in Europe. Furthermore, the euro-zone economy and euro stand to benefit more than the US from improving cyclical momentum in China. It has just been confirmed that China's economy bounced back more strongly than expected in Q1 and we expect upward momentum to continue in Q2. The better than expected growth outlook for the euro-zone economy is putting pressure on the ECB to raise rates further. We still expect the ECB to step down the pace of hikes at their next policy meeting on 4th May by delivering a 25bps hike but one can't rule out another larger 50bps hike. Chief Economist Lane signalled that both options remain on the table. Unlike the Fed we do not expect the ECB to signal that that are considering pausing their hiking cycle at this stage. In light of these developments we expect EUR/USD to move up into a higher trading range after breaking above the 1.1000-level on a more sustained basis.

INVESTOR SENTIMENT HAS SHIFTED IN FAVOUR OF STRONGER EURO



Source: Bloomberg, Macrobond & MUFG GMR

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Range**: 6.7500–6.9500**

In the past month, the pair was largely in a flat narrow range.

On 18th April, the National Bureau of Statistics released 1Q GDP and March data for China's major economic indicators, with quarterly GDP growth beating expectation, while monthly numbers lacking excitement. China's GDP growth was 4.5%yoy in the first quarter of the year after a 2.9%yoy increase in the prior quarter, beating market consensus of a 4.0%yoy expansion. The rebound in 1Q GDP growth was mainly driven by the tertiary sector, which grew by 5.4%yoy in Q1, up from 2.3%yoy in Q4 2022, with accommodation and catering trade accelerating by 19.4ppts in Q1, benefitting from the end of the "Zero-Covid" policy late last year.

This March, retail sales growth in year-over-over term offered a big positive surprise on the surface, with the year-over-year growth jumping up to 10.6%yoy, much stronger than what market expected and a nearly two-year high. Which reflects the positive effect of the release of pent-up demand for consumption typically happening in the post-pandemic era, along with the roll-out of stimulus measures by the government to boost consumption across the country. From the angle of expenditure measure of GDP, the stronger GDP growth in Q1 was largely due to improving consumption, so final consumption expenditure's share to China's overall GDP growth rose sharply to 66.6% in 1Q23 from a 32.8% in 4Q22. Looking ahead, we expect consumption to remain a key driver of further GDP growth acceleration through the rest of this year. With the upcoming Golden Week of May Day holidays (between 29th April 29 and 3rd May), it is likely to see more impetus into the economy from consumption side.

Orders of domestic travel in China for the May labour day holiday travel bookings in China as of 6th April have suppressed last year, and recovered to the pre-pandemic level in 2019, according to the travel booking site Trip.com. Also, as of 12th April, the number of bookings for related services on domestic bed and breakfast providers during the May labour day holiday has reached 2.3 times that of the same period in 2019, according to the booking platform Muniao.com.

While the y-o-y growth of retail sales surprised market to the upside, disappointment was felt in year-over-year growths of IP, FAI and property investment. More notably, March data shows that the growth momentums of several key macro variables were slower in March than February: in term of month-over-month change, retail sales grew only by 0.15%mom in March, lower than February's 0.67%mom; IP grew by 0.12%mom in March, same as February's 0.12%mom; FAI grew by -0.25%mom in March, worse than February's 0.48%mom expansion.

We expect China's exports growth to resume a decelerating trend after March's increase of 14.8%yoy. Exports to ASEAN, Russia and Africa, contributed 5.3ppts, 1.9ppts and 1.9ppts respectively to overall growth. Such surges are unlikely to be sustained, as it may due to the delay in exports production and delivery due to Covid-19 infection situation and Chinese New Year Holidays in the first two months of the year. Some orders may have delayed to later time in March, such one-time temporary factors are likely to fade.

March data indicated the pace of economic recovery was modest, also it reminded us that the recovery of property sector was still not solid. Having said it, we still think that various macro and industry policies and current recovery will help to nurture a stronger endogenous growth drive later this year. Recently, continued efforts were seen from the government to further stimulate the vitality of consumption and solidify consumption recovery. For example, China's Ministry of Culture and Tourism issued a Circular on 13th April, aiming to organize and carry out the 2023 cultural and tourism consumption promotion activities with the theme of "promoting cultural tourism consumption and sharing a better life". We have just revised our 2023 GDP growth forecast up to 5.5%

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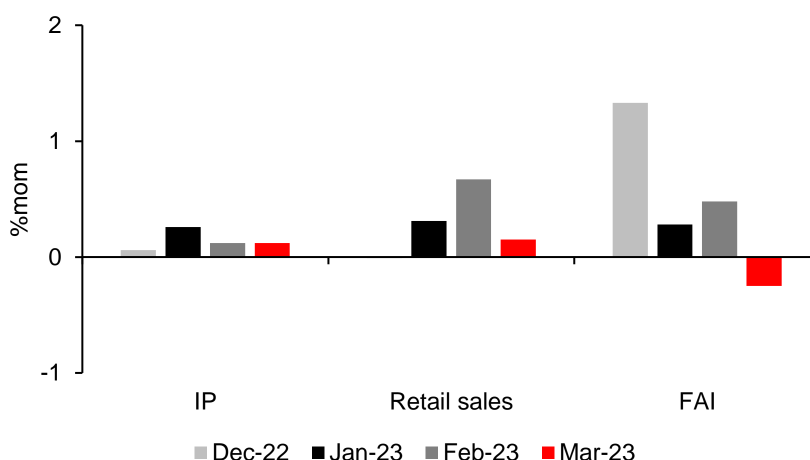
from 5.1%, in light of this better-than-expected Q1 GDP growth and recent policy initiatives.

The accelerating GDP growth of China this year stands in marked contrast to decelerating growth in the US and other major economies. Favourable domestic cyclical momentum will provide support for the CNY, and we continue to expect USD/CNY to reach 6.7500 by the end of Q2 although the decline may largely happen in June.

MARCH DATA INDICATED THE PACE OF ECONOMIC RECOVERY WAS MODEST



Source: CEIC, MUFG GMR

KEY RISK FACTORS IN THE MONTH AHEAD

- The primary risk to our USD/JPY view is that the current positive momentum is sustained for longer than expected. We currently expect the move higher to peter out but if the data from the US does not weaken as expected, market participants may continue to remove the pricing for rate cuts by year-end, which is now less than one 25bps cut. For the market to revert to a probability of further rate hikes further out towards year-end would require much stronger data for a longer period of time. Unlikely in our view but perhaps the primary risk to the view over the short-term. A stronger message from the BoJ that it has no intention to change YCC would also add to the risk.
- There are two main downside risks to our bullish EUR/USD bias in the month ahead. There is a risk that US rates move back to price in a more hawkish outlook for Fed policy if the fallout from the US regional banking crisis proves more modest than feared. The Fed could deliver another 25bps hike at the next FOMC meeting and leave the door open to further hikes this year. Alternatively, the USD could prove stronger than expected if fears over a US and/or global recession intensify that triggers a bout of safe have USD demand.
- Persisting geopolitical uncertainty remains an upside risk for USD/CNY in the month ahead. Huang Xilian, China's ambassador in the Philippines said on 14th April that the Philippines is stoking the fire of regional tensions by granting the US military wider access to some of its military bases, with three facing north towards Taiwan and one near the disputed Spratly Islands in the South China Sea.

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