Global Markets Monthly

JANUARY 2022

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

DEREK HALPENNY
Head of Research,
Global Markets EMEA and International Securities
Global Markets Research
Global Markets Division for EMEA
E: Derek.Halpenny@uk.mufg.jp

LEE HARDMAN
Currency Analyst
Global Markets Research
Global Markets Division for EMEA
E: Lee.Hardman@uk.mufg.jp

LIN LI
Head of Global Markets Research Asia
Global Markets Division for Asia
E: Lin_Li@hk.mufg.jp

HENRY COOK
Europe Economist
MUFG Bank
E: Henry.Cook@uk.mufg.jp

GEORGE GONCALVES
Head of U.S. Macro Strategy
Institutional Client Group
MUFG Securities Americas, Inc
E: George.Goncalves@mufgsecurities.com

ERIC RUFF
Director
Credit Trading Group
U.S. Investment Grade
MUFG Securities Americas Inc.
E: Eric.Ruff@mufgsecurities.com

BILL MATTHEWS
Director
Credit Trading Group
U.S. High Yield
MUFG Securities Americas Inc.
E; Bill.Matthews@mufgsecurities.com

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HENRY COOK
Europe Economist

MUFG Bank

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

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Global Macro – European themes

The hit to the European economy from Omicron is set to be milder than during previous waves and activity should rebound sharply by Q2 as restrictions are lifted. But global supply chain problems may prove more persistent, pushing up inflation for longer. With higher energy costs eroding savings accumulated during the pandemic, consumer spending may not be as useful a growth driver as hoped.

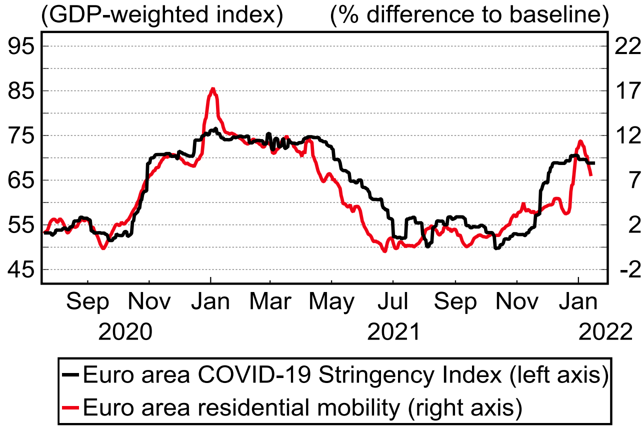
A RELATIVELY MILD HIT TO GROWTH

COVID cases in the EU/EEA and UK have soared to over three times that of the previous peak. However, in terms of clinical outcomes, the Omicron variant is proving to be relatively mild. Helped by the rapid expansion of vaccine booster programmes through the winter, there has not been an increase in the rate of COVID deaths in the region as a whole since mid-December. The number of patients in mechanical ventilation beds in the UK, which has experienced one of the sharpest waves, has actually decreased slightly over the last two months.

This health situation has not demanded hard lockdown measures in most European countries. Instead, government measures have been focused on customer-facing hospitality industries and less economically-disruptive measures such as mandates for employees to work remotely if possible. In many cases, the most restrictive measures were reserved for unvaccinated measures. A GDP-weighted stringency index for the euro area as a whole has not increased meaningfully since December and has remained below the levels seen during the previous winter wave of the virus.

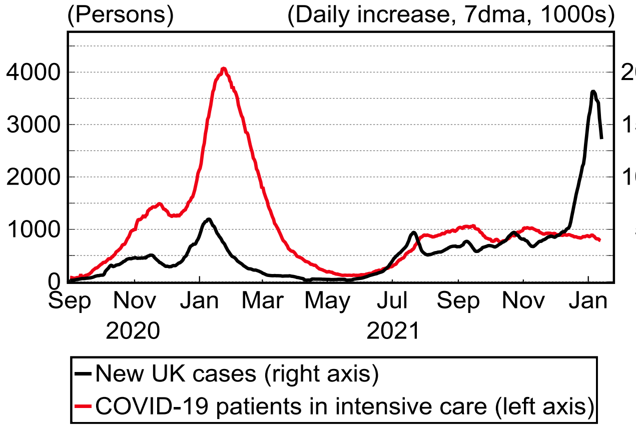
While the economy has proved to be increasingly resilient to COVID restrictions, the measures that are in place have combined with voluntary social distancing and high worker absence to drag on GDP around the turn of the year. The German statistical agency has already suggested that the German economy contracted in Q4 last year. We have revised down our growth prospects for European economies this year: we now expect annual average growth in 2022 of 3.7% in the euro area (from 4.3% in our previous forecasts) and 4.5% in the UK (from 5.2%).

RESTRICTIONS REMAIN LOOSER THAN LAST WINTER



Source: Oxford COVID-19 Government Response Tracker, Google, MUFG Bank ERO

UK CASELOAD: PAST THE PEAK?



Source: ONS, NHS, MUFG Bank ERO

However, the hit from Omicron to euro area and UK activity is set to be much milder than during previous COVID waves. It may also be shorter. At this stage it is unlikely that significant new measures will be implemented in most countries. Indeed, some countries have now started to ease self-isolation requirements and travel restrictions

Encouragingly, daily cases in the UK now appear to have peaked and the seven-day average is falling relatively quickly. This may well be mirrored in other European countries over coming weeks, especially those with high booster uptake rates, in which case the hit to economic activity would be focused on December and January only. From mid to late Q1 we expect activity to rebound across Europe with the recovery especially pronounced in customer-facing industries. As noted before (here) we see no reason to assume that the latest COVID wave will lead to a higher degree of long-term economic scarring. We expect that a similar level of GDP to our previous forecasts will be reached by 2023 with growth picking up strongly later this year.

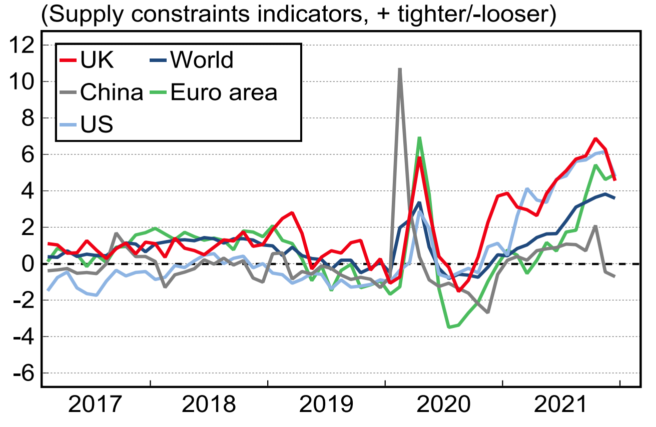
On the future of COVID, the UK may well lead the way on the transition from a 'pandemic' to 'endemic' footing for developed countries in Europe. As mentioned above, UK cases are already falling and the government seems set to withdraw most if not all COVID restrictions on 26 January. There will be uncertainty around individual behaviour during any subsequent COVID spikes. But we expect that, in the absence of more severe variants, government interventions in the UK and other European countries will become increasingly gentle and less relevant to economic activity (perhaps remote working might be encouraged during winter months, for example).

CLOSE TO THE INFLATION PEAK

At the start of the Omicron wave it was unclear if increased supply-chain friction or reduced demand would dominate when it came to inflation, but it now seems clear that Omicron will mean higher inflation for longer in Europe as the easing of bottlenecks is temporarily slowed or even reversed.

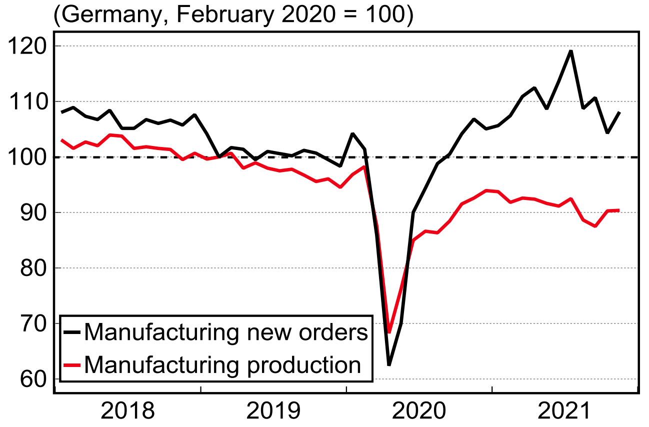
China remains wedded to its 'COVID-zero' approach response and there have been reports of congestion and reduced services at major ports. There had been tentative signs of easing supply issues before the start of the Omicron wave but they now seem set to push up inflation for longer. Bottlenecks will also drag on European manufacturing well into H1 this year. The good news is that demand remains strong: while manufacturing output rose by just 0.1% m/m in Germany in November, new orders increased by 3.7% m/m. Industry could be a key growth driver by year-end.

SOME SIGNS OF EASING SUPPLY CONSTRAINTS



Based on Chart 2.3 of the November 2021 BoE Monetary Policy Report. Source: IHS Markit, BoE, MUFG Bank ERO

MANUFACTURING: DEMAND REMAINS FIRM



Source: Destatis, MUFG Bank ERO

The supply chain story is likely to remain important for longer but most of the immediate pressure on headline inflation is coming from commodities. Wholesale gas prices are up around 300% over the past year. An unusually cold period of weather could push prices up again, but our expectation is that the energy contribution to inflation will fall rapidly in H2 this year. Euro area inflation reached a record high of 5% last month. This is probably close to the peak, even allowing for any Omicron effect on supply chains. The effect of the VAT reversal in Germany, which came into force last January, will slip out of this month's figures. By year-end it would be no surprise to see low or even negative monthly rates. In the UK, the peak (we look for around 6.5%) is likely to come in April when the household energy price cap could be increased by around 50%.

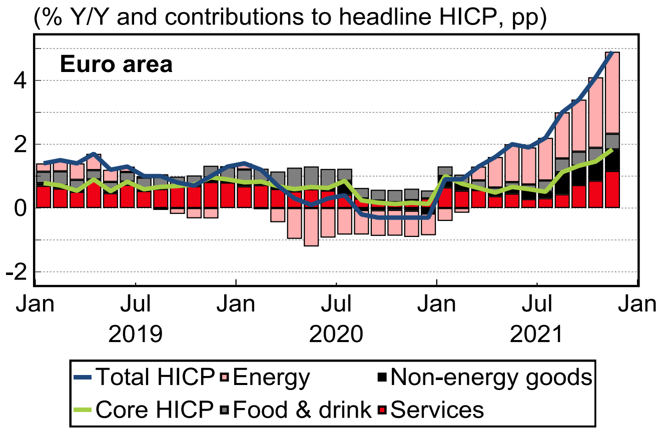
Further ahead, Omicron is unlikely to change the long-term inflation outlook. We are sticking with our view that the pandemic is unlikely to cause a significant regime shift in inflation. Secular trends in demographics and technology, which have weighed down on price growth for decades, should reassert themselves. Post-pandemic changes such as remote working and remote shopping may have a similar effect, offsetting any inflationary pressures from 're-shoring' of manufacturing after supply disruptions.

REDUCED SCOPE FOR A CONSUMER-DRIVEN SURGE

Euro area unemployment fell to 7.2% in November, close to the pre-pandemic rate, but we think there is considerable slack in the labour market and so expect that real household consumer incomes will come under pressure this year. Negotiated wages rose by just 1.35% in in the euro area in Q3 last year (a historical low) despite high vacancy rates and widespread reports of labour shortages. The gauge is likely to increase but we do not expect runaway pay growth. Inflation expectations appear to remain well-anchored and it's not clear that employees have a great deal of bargaining power. As is the case in the US, labour force participation rates remain below the pre-pandemic levels. As savings accumulated during the pandemic start to dwindle we expect that more workers will re-enter the labour force, pushing down on wage growth.

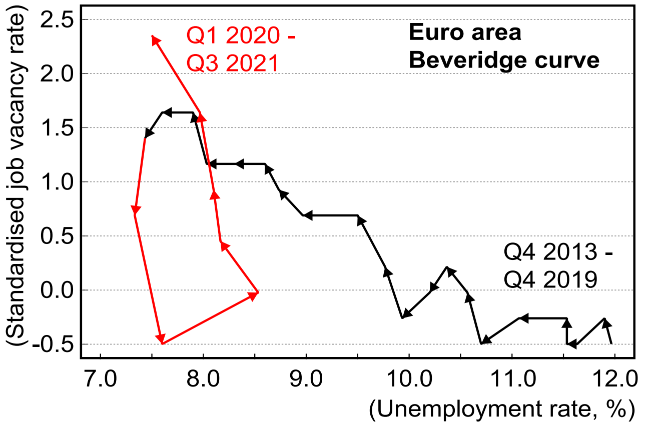
Consumer confidence in the euro area fell last month but remains above its long-term average (and actually at its December 2019 level) despite the spread of Omicron. With inflation normalising in H2, we still expect consumer spending to be a key growth driver this year, but the outlook is becoming more challenging. As the buffer provided by pandemic-accumulated savings is eroded by higher energy costs and persistent supply chain issues push up goods prices for longer, the chances of a consumer spending upside scenario for growth in 2022 is diminishing.

ENERGY HAS DRIVEN EURO AREA INFLATION TO A RECORD HIGH



Source: Eurostat, MUFG Bank ERO

SOARING VACANCIES BUT ONLY A STEADY IMPROVEMENT IN THE UNEMPLOYMENT RATE



Source: Eurostat, MUFG Bank ERO

GEORGE GONCALVES
Head of U.S. Macro Strategy

Institutional Client Group
MUFG Securities Americas Inc.
T: +1-212-405-6687
E: george.goncalves@mufgsecurities.com

ERIC RUFF
Director

Credit Trading Group
U.S. Investment Grade
MUFG Securities Americas Inc.

T: +1-212-405-7489
E: Eric.Ruff@mufgsecurities.com

BILL MATTHEWS
Director

Credit Trading Group
U.S. High Yield
MUFG Securities Americas Inc.

T : +1-212-405-7486
E : Bill.Matthews@mufgsecurities.com

Mitsubishi UFJ Securities
A member of MUFG, a global financial group

US Fixed Income: It's all about financial conditions

Macro Thoughts: US data is starting to show signs of some early deceleration with a weak retail sales, submerged consumer sentiment and a recently mixed jobs report. The one silver lining from the latest NFP was the higher than expected results from the wages category. Inflation set a new high for this cycle at 7% per annum in December. We do not view the recent bout of weakness as the start of something more meaningful as we expect economic activity to pick up once the latest wave of the CV19 omicron strand starts to recede come spring.

Fed Policy: We see potential for 3 rate hikes this year – where the starting point depends on financial conditions as we head into the March FOMC. Markets are already expecting March as the starting point for this hiking cycle. In general Fed policy should be pulled forward into the 1st half as this is when inflation will be of upmost concern. In terms of balance-sheet and general QE policy, the Fed is poised to complete the tapering of QE by March. Beyond that we believe the balance-sheet will also begin to shrink with the question now being more about timing (i.e. will it be between the first hikes). From here on out every FOMC (and in many ways the minutes might matter more for the details) will be revealing of the Fed's next steps.

Rates Views: The rise in rates has been fast and furious as 2022 gets on its way. The rates shock has led to broad underperformance for all assets that trade with duration. As per our recently updated US rates forecasts on the Bloomberg terminal, we now expect long-term rates to continue to rise but ultimately peak sometime in the 1st half of 2022. We believe 10s may trade in and around 2% in anticipation of multiple hikes and the eventual start of the Fed's balance-sheet roll-off (otherwise known as quantitative tightening – or QT for short).

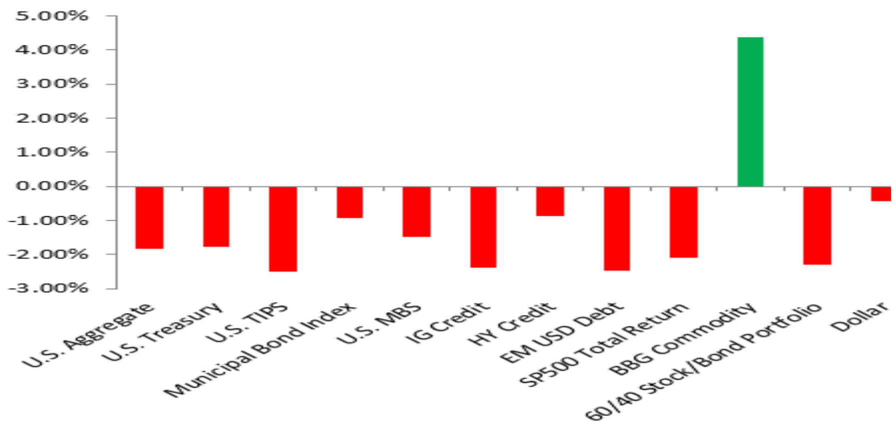
Credit Views: We see macro risks surfacing on an episodic basis in both the IG and HY credit markets. Our house view revolves around the risk of tighter financial conditions as the Fed aims to contain inflation at a time that risk market metrics are stretched. That said we are generally constructive on the IG Market in 2022, as there are a number of positive factors going for the asset class and in general credit should weather any sort of short-term market volatility. Strong corporate earnings are likely to continue, at least into the first half, assuming no major disruptions and default rates are expected to stay low. This is largely true for the HY market too. We also feel that the higher all-in yields are starting to offer some value for HY investors.

RATES ON THE MOVE WITH FINANCIAL CONDITIONS IN FOCUS

In response to the hawkish Fed minutes in early January and ongoing Fed speakers stating the need to hike multiple times but also the desire to begin the process of shrinking the balance-sheet, a higher rates backdrop has led to one of the worst starts (in total returns) of any year for the USD-based asset classes that we track.

As per this next chart, one of the few asset classes that are performing well is commodities (its up over 400bps in total return on the year as per the Bloomberg commodity index). Meanwhile the major US fixed income sectors, from the broader aggregate index to high yield (and everything else in between) has seen negative returns ranging from -87bps to -250bps. Mind you this happened in just two weeks!

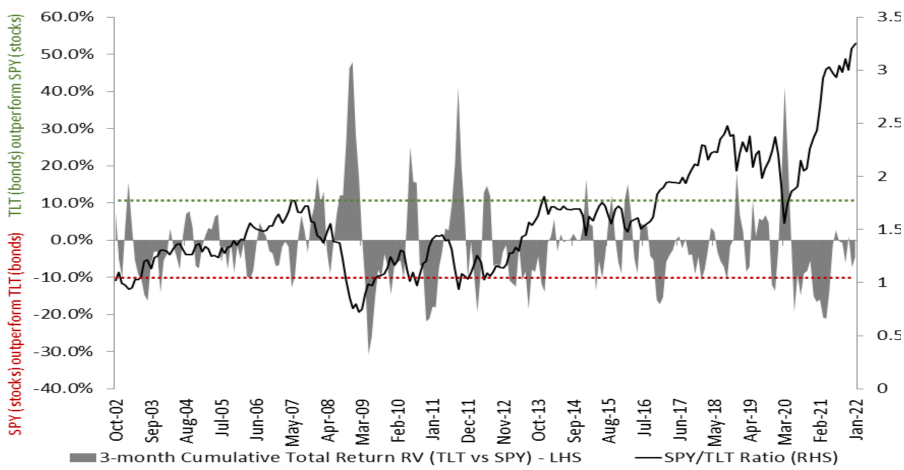
YEAR-TO-DATE RETURNS ACROSS SELECT USD-BASED ASSET CLASSES



Source: Bloomberg, MUFG U.S. Macro Strategy

As we have mentioned before, if US financial conditions tighten sufficiently this year, eventually there should be a feedback loop mechanism that will see flows back into US fixed income (especially the liquid product space of USTs & MBS, but also into IG to a certain extent). This is one of the reasons why we have a shallower path for long-term rates versus short-term rates. We think most of the discounting of higher rates will continually come from short-term rates (that eventually push up all rates).

STOCKS/BONDS INDEX RATIO VS 3-MONTH CUMULATIVE TOTAL RETURN RV



Source: Bloomberg, MUFG U.S. Macro Strategy

Thus we believe watching stocks and the relative performance to bonds will be of great interest as the year progresses. As we can see from the chart above, using the SPY and TLT proxies for a Stocks-to-Bonds ratio, we see that stocks have never been richer. Typically whenever this ratio relapses it does so from stocks declining but also bonds rallying. With the Fed hiking it may make the latter a bit trickier, at least in the 1st half. However if financial conditions tighten in phases, where we see more than just a wave, we presume at least one decent long bond rally in 2022 too.

CREDIT FUNDAMENTALS TO OFFSET RATE RISK, FOR NOW

2021 was a fair year for IG credit, as most of the year reflected the recovery from the COVID crisis of 2020, as the vaccine rollout helped travel/business restrictions ease. However, most of the IG gains were given back just in December alone as markets repriced over economic concerns of the omicron variant coupled with the Fed's hawkish turn and multiple expected rate rises next year. Total Return for IG in 2021 is -1.04%, due to the rise in Treasury yields. However from an excess return point of view (i.e. excess returns net of Treasury returns) 2021 saw 1.53% gains, compared to 0.5% for 2020, 6.76% for 2019, and 0.78% over a long-term historical average.

US INVESTMENT GRADE EXCESS RETURNS WITH KEY EVENTS OVERLAY

Source: Bloomberg, MUFG U.S. Macro Strategy

Thus far in 2022, the first two weeks into the new year has been a slow start for IG credit, with the aggregate IG index total return -1.69% and the excess return coming in at -0.30%. We attribute this weak start to the following: The surprising move up in Treasuries, with the 10-year yield rising 24 bps to 1.74% in just the first two weeks. Total IG credit spreads are 3 bps wider to 96 bps. Stock indices are lower, with the S&P 500 down over 2%. Investors are also bracing for higher supply on very heavy primary new issuance volume, with $99.5bn issued MTD, compared to $74.5bn for the same period last year. Consensus for January is $140bn and estimates for the full year are about $1.3 trillion. Investors appear to be generally cautious so far, possibly waiting for rates to stabilize and for the new issuance calendar to slow a bit.

IG SECTOR SPREADS AND TOTAL RETURNS

OAS AND SPREAD CHANGES						TOTAL RETURNS		EXCESS RETURNS	
Sector	OAS	1 Month	YTD	1 Year	YTW	YTD (%)	12 M	YTD (%)	12M
Total IG	96	-2	3	3	2.54%	-1.69%	-1.65%	-0.30%	1.04%
Financial Institutions	88	-1	4	6	2.33%	-1.37%	-1.62%	-0.28%	0.78%
Utility	107	-3	0	4	2.80%	-1.75%	-2.36%	-0.06%	0.81%
Energy	118	-4	1	-10	2.78%	-1.52%	0.32%	-0.12%	2.95%
Basic	119	-1	4	6	2.88%	-1.83%	-1.63%	-0.23%	1.45%
Capital Goods	87	-5	1	-8	2.45%	-1.52%	-1.03%	-0.14%	1.82%
Technology	85	-2	4	11	2.44%	-1.88%	-2.56%	-0.47%	0.03%
Communications	124	-3	6	6	2.98%	-2.40%	-1.78%	-0.68%	1.19%
Consumer Noncyclical	90	-4	3	5	2.57%	-1.91%	-2.11%	-0.34%	0.77%
Pharmaceuticals	79	-5	3	6	2.44%	-1.96%	-2.57%	-0.41%	0.33%
Food/Beverage	92	-3	3	2	2.60%	-1.98%	-1.69%	-0.39%	1.16%
Consumer Cyclical	81	-3	3	-1	2.33%	-1.52%	-1.64%	-0.25%	0.90%
Transportation	98	-5	0	-11	2.69%	-1.80%	-0.97%	-0.11%	1.79%

Source: Bloomberg, MUFG U.S. Macro Strategy

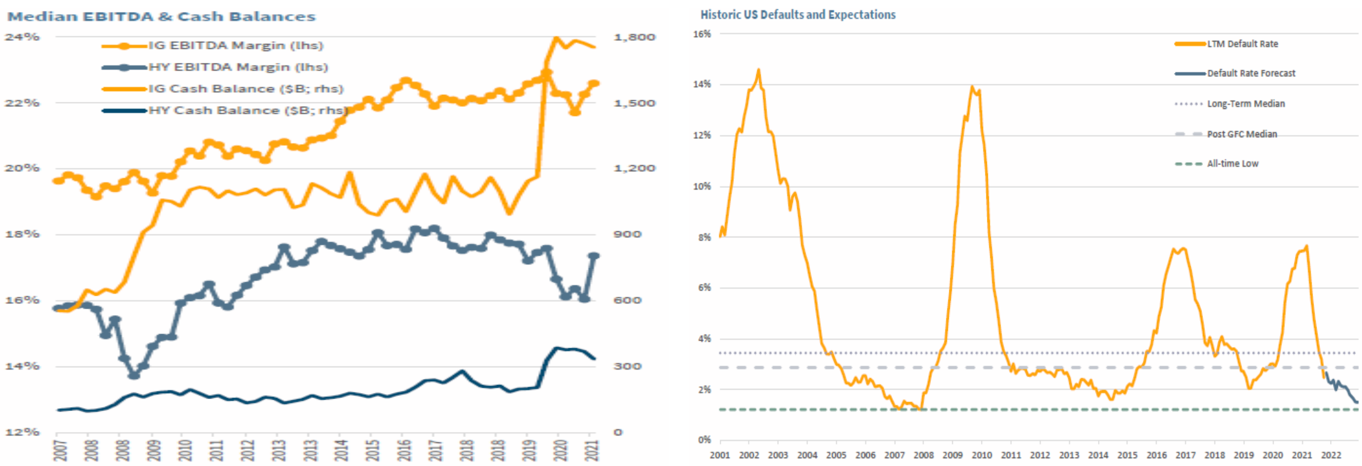
At the IG sector level, utilities have had the strongest performance so far in January, with excess return of -0.06%, but with spreads flat, while Communications was the laggard at -0.68%, with spreads widening the most by about 6 bps.

Investment Grade Spread Forecast for 2022: We expect aggregate IG credit spreads to trade in a range of 85 – 125 bps compared to 96 currently, as we believe spreads are weighted more towards widening than tightening due to expected rise in rates coupled with our US house view of some economic deceleration in the second half of 2022. The 85 bps is close to the full year 2021 average of 89 bps. The 125 bps is the widest level since November 2, 2020, before the COVID vaccine roll-outs.

We see macro risks surfacing on an episodic basis (as our house view revolves around the risk of tighter financial conditions as the Fed aims to contain inflation at a time that risk market metrics are stretched), we are generally constructive on the IG Market in 2022, as there are a number of positive factors going for the asset class.

Strong corporate earnings are likely to continue, at least into the first half, assuming no major economic disruptions. And corporate balance sheets remain healthy, with near record high levels of cash balances ($1.8 trillion across IG - see Chart 3 below).

CASH BALANCES (LEFT) VERSUS US CREDIT DEFAULT RATES (RIGHT)



Source: CreditSights, FactSet, ICE Data Indices, LLC

Relatively low IG corporate leverage of 3.22x, in the middle of the 3-year average of 3.29x (but above the 10-year average of 2.92x). Very low corporate default rates that could approach a near all-time low of 1.75% (see chart above). Meanwhile primary debt issuance is healthy as companies aim to refinance upcoming maturities at lower rates before the Fed starts hiking. Current market estimates average about $1.3 trillion of new issuance in 2022, just slightly behind the $1.49 trillion issued in 2021.

High Yield Spread Forecast for 2022: With a lower duration footprint versus IG credit, but still benefiting from strong corporate earnings and low default rates, we continue to expect spread performance to remain in check. As with all credit, the risks remain linked to financial conditions tightening, due to either a Fed overshoot and/or an adverse reaction in broader markets given elevated risk valuations. We expect spreads to remain toward the tighter end of our 285-385bp range for 2022.

That said, the high yield market is off to its worst star in six years with a total return of -0.7% through the first eight trading days of the year. In the end it's all about rates! A more hawkish Fed has driven rates higher at faster pace than previously anticipated and spreads widened for all industries. We anticipate eventually some tightening as the market comes to terms with a fast Fed and volatility in rates abates. YTD, CCCs have outperformed returning -0.16 vs -1.03 for BB and -0.32 for B. We favor select, high quality CCC and single B names with total return potential and limited duration risk. The OAS on the index stands at 293 at the tight end of our range of 285-385.

With the broader index now yielding a YTW at 4.50%, we feel the High Yield offers good value in a strong economic environment with expected record low defaults

DEREK HALPENNY
Head of Research,
Global Markets EMEA and International Securities

Global Markets Research
Global Markets Division for EMEA
T: +44 (0)20 7577 1887
E: Derek.Halpenny@uk.mufg.jp

LEE HARDMAN
Currency Analyst

Global Markets Research
Global Markets Division for EMEA
T: +44 (0)20 7577 1968
E: Lee.Hardman@uk.mufg.jp

LIN LI
Head of Global Markets Research Asia

Global Markets Research
Global Markets Division for Asia
T: +852 2862 7005
E: Lin_Li@hk.mufg.jp

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FX

The US dollar on a DXY basis has struggled since the start of the year which is notable given the continued increase in US yields as market participants position for the commencement of monetary tightening by the Federal Reserve, possibly at the March FOMC meeting. We certainly believe this is partly explained by positioning. IMM data currently show close to the largest long USD position amongst Leveraged Funds since January 2019. So FX looks well priced for Fed action. Secondly, the OIS market and the fed funds futures market both show a peak fed funds rate still below 2%, well below the 2.50% Fed estimate. We suspect this could grind higher though and that could be the catalyst for some renewed US dollar strength. To what extent, and versus which currencies will depend on how challenging financial market conditions become. The more volatile markets become, the more dollar strength will be versus the high-beta global growth sensitive currencies.

BASE CASE EXPECTATIONS, JPY, EUR & CNY

USD/JPY – BULLISH BIAS

- **Range: 112.00-117.00**

We breached the upper-end of our range (116.00) since we last published here but then corrected sharply lower with some emergence of less than stellar performance of risk assets that may have reinforced the appetite to liquidate short JPY positions. Certainly positioning was a factor given the IMM data indicating sizeable short JPY positions have persisted. From intra-day high-to-low in January, USD/JPY fell 2.5% and that may well make market participants somewhat reluctant to jump back into shorting JPY. Furthermore, the failure to test the long-term resistance trendline (from 1990 & 2015 intra-day highs) could have further reinforced the sell-off and USD/JPY.

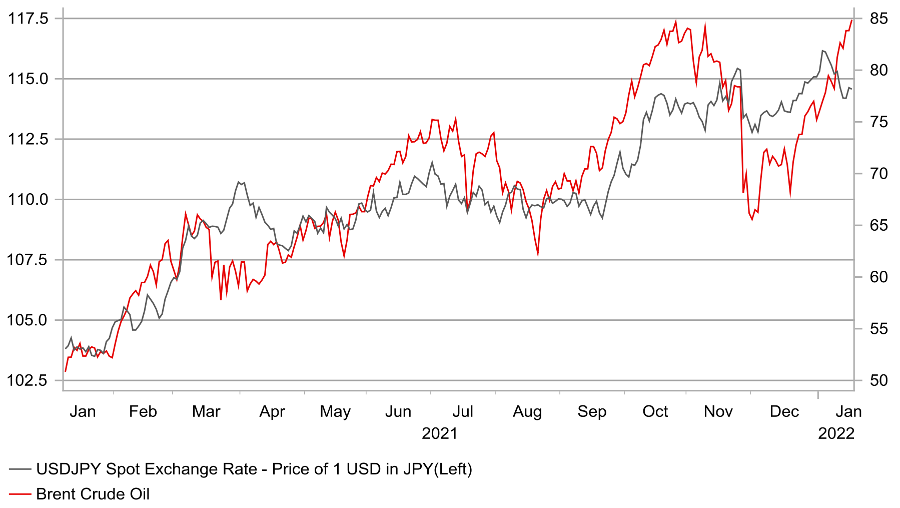
The sell-off in January in USD/JPY was also partly fuelled by a Reuters report that the BoJ was discussing how to communicate to the financial markets that the BoJ was commencing plans on eventually raising rates. We saw plenty of reason to be dubious of this report. Inflation in Japan is much less threatening than in other major developed economies with the divergence between core Nationwide annual CPI (which includes energy) and core-core Nationwide annual CPI (which excludes energy) widening to a level not seen since 2008 when crude oil prices were marching to record highs of USD 160pbl. Furthermore, the timing was dubious. With JPY weakness at an extreme, it raised the risk of a very disruptive spurt of JPY strength that would have been very deflationary. Unsurprisingly, BoJ Kuroda dismissed this report and emphasised the continuation of ultra-lose policy. He also spoke of the merits of currency depreciation.

So we see a favourable backdrop for USD/JPY to retrace back to the highs recorded earlier this month. What could scupper that view is increased equity market volatility that curtails renewed risk appetite. In that context, we have a close eye on the Nasdaq Composite in the US where we may be seeing the early signs of the negative impact of higher US yields. The Nasdaq 100 is now almost 10% below the November peak and a further correction lower may mean JPY selling is subdued.

Nonetheless, with QE ongoing for now and the withdrawal of liquidity not imminent, we do not see those challenging financial market conditions as imminent and that should mean a window for renewed JPY selling emerges over the short-term.

There is also the potential for cross-border flows to provide some support for USD/JPY. Fiscal year-to-date has seen very subdued outflows from Japan. Japan investors have bought just JPY 1,446bn worth of foreign bonds this fiscal year through to December, the lowest total since FY13. With yields higher now there is scope for demand to pick up which could provide USD/JPY with support, especially at lower levels. Crude oil prices are also surging again and there had been until recently a notable correlation with JPY weakness. Brent crude oil prices are up over 12% since the turn of the year and by 27% since the start of December. We do not see JPY depreciation being sustained throughout the year but there remains a widow for depreciation over the short-term.

USD/JPY VERSUS BRENT CRUDE OIL SINCE THE START OF 2021



Source: Bloomberg, Macrobond, MUFG GMR

EUR/USD – BEARISH BIAS

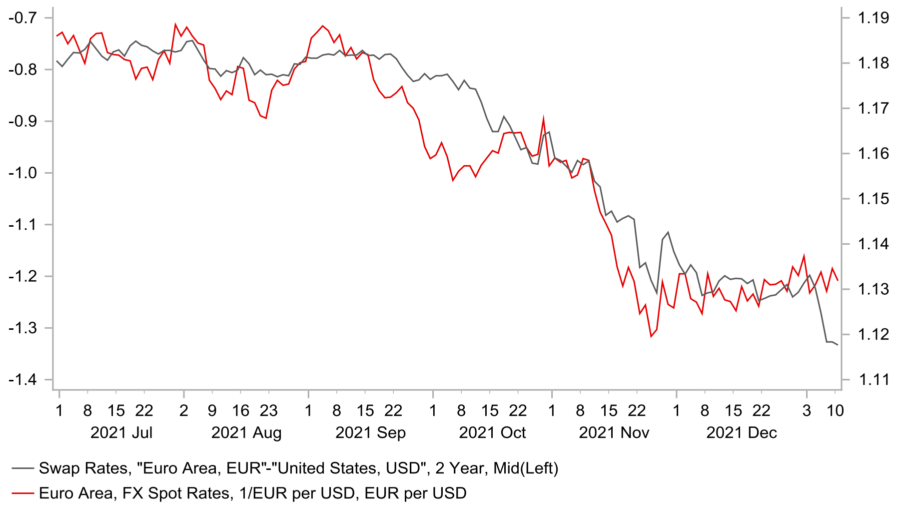
- **Range: 1.1100-1.1650**

The EUR has staged a modest rebound against the USD after putting in place a low of 1.1186 on 24th November. It brought an end to four consecutive months of lower closes for EUR/USD between August and November. The pair has found more support closer to the 1.1000-level similar to between 2015 and early 2017, and more recently between late 2019 and early 2020. The price action fits with our view that the EUR has become more deeply undervalued against the US dollar which is helping to dampen further downside risks in the near-term. Our long-term PPP model estimates that EUR/USD is currently trading around one standard deviation below fair value which comes in at around 1.1250. It was only back in the early 2000's that EUR/USD traded at even more extreme levels of undervaluation for a more sustained period of time.

It has been notable over the past month that the USD failed to strengthen further on the back of the Fed's hawkish policy shift. The US rate market has moved to price in faster pace of Fed tightening resulting US yields hitting fresh highs both in nominal and real terms but there has been little follow through so far to a stronger USD. It has encouraged speculation that the USD could be close to peaking out. There is a high hurdle for the Fed to exceed market expectations for up to four rate hikes this year. However, we remain unconvinced yet that the USD will trend lower on sustained basis at the current juncture. There is still room to price in more Fed hikes further out the curve and price in a higher terminal rate. Additionally, the Fed could announce plans to begin shrinking their balance sheet sooner and more quickly than in the last tightening cycle. As a result, we still expect EUR/USD to trade closer to the 1.1000-level in Q1 before drifting gradually higher later this year.

One potential trigger for a weaker EUR in the month ahead is posed by rising geopolitical tensions between Russia and the West. Diplomatic talks with the US and NATO failed to reach a compromise agreement with Russia keeping alive the risk of another invasion of the Ukraine. If a diplomatic solution is not found, a further escalation in tensions could put more upward pressure on European gas prices and thereby reinforce the negative hit to Europe's economy from a squeeze on real incomes.

EUR/USD HAS RECENTLY FAILED TO FOLLOW YIELD SPREADS



Source: Bloomberg, Macrobond & MUFG GMR

USD/CNY – BULLISH BIAS

Range**: 6.3500–6.4000**

China released Q4 GDP and December's numbers for key macroeconomic indicators. While December's year-over-year growth of industrial production increased, Q4's year-over-year GDP growth and December's year-over-year growths of retail sales, YTD fixed assets investment and YTD property investments all declined from their values in prior December to 5.1% period. One of the major labour market indicators, surveyed jobless rate also worsened in from November's 5.0%.

Real GDP growth continued on its decelerating path in Q4 with a 4%yoy reported, further declining from the 4.9%yoy in Q3. The drag of the Chinese economy was still the continued slowdown in growths of real estate activities, weak infrastructure investment, and weak consumption which was hit by lingering Covid-19 situation. The retail sales only grew by 1.7%yoy in December, further down from November's 3.9yoy. In 2-year CAGR term, retail sales growth fell by 1.3ppts to 3.1%yoy 2-year CAGR, far below the pre-pandemic level and households income growth. Just three weeks before the Winter Olympics, China is recording increasing cases of Omicron variant. As of January 17th, China reported 171 daily new confirmed cases, among which 43 are imported cases. Given China's "ZERO Covid-19" policy, current numbers of daily new cases imply a possible step-up in pandemic control. The sentiment for consumption and investment is unlikely to improve in near term. This, together with the persisting downward pressure in real estate sector and Winter

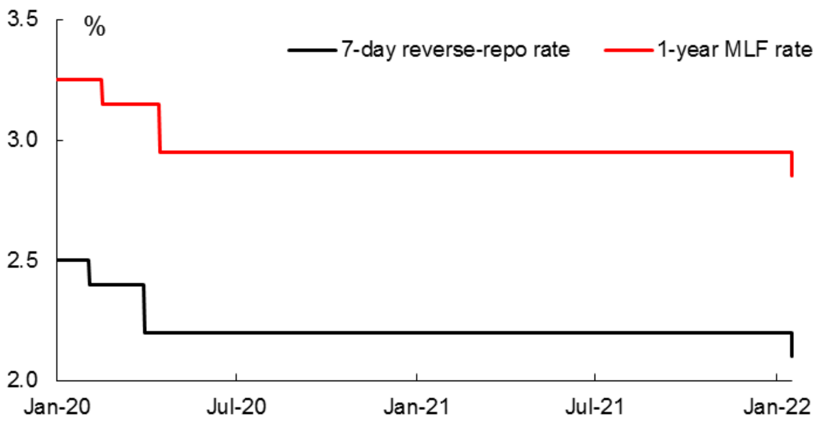
Olympic, implies a weaker GDP growth in Q1. The deceleration of property investment growth was sharp in the recent couple months, and property investment grew by 4.4%yoy in the full year of 2021, much lower than its 15.0%yoy growth for the first half of the 2021. Additionally, various real estate activity indicators, including YTD floor space started, YTD property sold, YTD floor space under construction, all showed the decelerating year-over-year growth in December.

In contrast with weak domestic fundamentals, China's exports continued to grow strongly, with exports (in USD term) growth being at 20.9%yoy in December. The trade surplus rose to a record high of USD94.46 billion in December, up sharply from the USD71.72 billion surplus. The spreading of Omicron in elsewhere and associated delayed recovery in supply/demand imbalance helped to explain the strong exports of China, and suggest the near term strength of China's exports as well.

In the same day of the release of a set of weak December economic numbers, PBOC cut its policy rate of 1-year Medium-Term Lending Facility (MLF) rate by 10bps to 2.85%, the first reduction since April 2020, and cut 7-day reverse repo rate by also 10bps to 2.1%. PBOC's action of rates cut clearly indicates the government's intention to stabilize growth. Looking ahead, given China's Q1 growth likely goes weaker, we expect further mild cuts on MLF and/or 7D repo, and/or RRR in the rest of Q1, as next couple months offer a good window, with PPI inflation further moderating and Fed's rate hikes still being several months away.

In the near term, the interest rate differential would work against CNY (against US dollar), but CNY will likely remain supported by good trade surplus and be disconnected with domestic fundamentals in near term. Balancing all these, we see USD/CNY to move in a narrow range between 6.3500 and 6.4000 in the month ahead.

10 BPS CUT ON 1-YEAR MLF & 7-DAY REVERSE REPO



Source: Bloomberg, MUFG GMR

KEY RISK FACTORS IN THE MONTHS AHEAD

- The key risk to our bullish USD/JPY bias over the short-term is that the challenging financial market conditions we expect to emerge happen sooner than expected. It is perhaps a greater risk than usual given there are some signs of equity market weakness – especially in tech. If that extends further it could see JPY continue to outperform over the short-term.
- There is a building risk that the sharp move higher in US yields at the start of the New Year could destabilize financial market conditions. If market participants become more fearful over a faster pace of policy normalization from the Fed and other major central banks it could trigger a larger correction lower for risk assets.

A period of position liquidation could temporarily benefit the EUR more than USD helping to lift EUR/USD towards the top of our monthly range. The EUR has tended to outperform during periods of risk aversion in recent years.

- The main risks to our modest bullish bias for USD/CNY may still include stronger China's exports and stronger than expected capital inflows, stronger than expected easing policies including credit policies for real estate sector and property purchasers, to stabilize the downward economic pressure.

Global Markets Research

FX

Head of Research, Global Markets EMEA
and International Securities

DEREK HALPENNY
Managing Director
T: +44 (0)20 7577 1887 E: Derek.Halpenny@uk.mufg.jp

Head of Global Markets Research, Asia

LIN LI
Managing Director
T: +852 2862 7005 E: Lin_Li@hk.mufg.jp

Currency Analyst (Asean)

SOPHIA NG
Associate
T: +65 6918 5537 E: Sophia.Ng@sg.mufg.jp

Currency Analyst (Europe)

LEE HARDMAN
Vice President
T: +44 (0)20 7577 1965   E: Lee.Hardman@uk.mufg.jp

Head of Emerging Markets Research, EMEA

EHSAN KHOMAN
Director
T: +971 4 387 5033   E: Ehsan.Khoman@ae.mufg.jp

Head of U.S. Macro Strategy

GEORGE GONCALVES
Director
T: + 1-212-405-6687 E: George.Goncalves@mufgsecurities.com

Credit Strategy

Corporate Credit (Europe)

KONRAD BOSZKO, CFA
Director
T: +44 (0)20 7577 2352 E: Konrad.Boszko@mufgsecurities.com

Investment Grade Healthcare, TMT, Consumer (US)

ERIC RUFF
Director
T: +1 212 405 7489 E: Eric.Ruff @mufgsecurities.com

High Yield (US)

BILL MATTHEWS
Director
T: +1 212 405 7486 E: Bill.Matthews@mufgsecurities.com

Financial Credit (Europe)

CARLO MAREELS
Director
T: +44 (0)20 7577 2927 E: Carlo.Mareels@mufgsecurities.com

Investment Grade Utilities, Energy, Industrials (US)

DANIEL VOLPI
Director
T: +1 212 405 7328 E: Daniel.Volpi@mufgsecurities.com

Investment Grade TMT, Consumer, Retail (US)

ANDREW MYERS
Vice President
T: +1 212 405 7497 E: Andrew.Myers@mufgsecurities.com

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