GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

Global Markets Monitor

FRIDAY, JULY 23, 2021

- **Markets reassess upcoming FOMC meeting** (link)
- **Euro area composite PMI hits 21-year high** (link)
- **Survey finds investors are confident US inflation is temporary** (link)
- **Chinese stocks decline on fears of more regulatory crackdowns** (link)
- **Bullish sentiment buoys US high yield market** (link)
- **Russia hikes policy rate to combat rising inflation** (link)

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Global stocks approach all-time highs

Markets are looking at a fourth consecutive day of gains and are in striking distance of new all-time highs. Robust corporate profits are a key driver of sentiment as the Q2 2021 earnings season delivers results that are stronger than most expectations. Treasury yields appear to have bounced off their lows from earlier in the week, further reassuring investors. Survey data show that investors agree with the US Fed that elevated inflation is a temporary phenomenon, suggesting that another key risk is abating. However, recent market moves have been relatively small ahead of important risk events next week, including the July 28 FOMC meeting and the latest report on US core PCE inflation. Stocks in China were under pressure on fears of more regulatory crackdowns, while emerging market central banks are confronting hike rates as inflationary pressures build. Meanwhile, the dollar index was stronger again and oil prices were slightly lower.

Key Global Financial Indicators

Last updated: 7/23/21 8:06 AM	Level		Change from Market Close				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
Equities					%		%
S&P 500		4367	0.2	0	3	35	16
Eurostoxx 50		4101	1.0	2	1	22	15
Nikkei 225		27548	0.6	-4	-5	21	0
MSCI EM		53	0.2	-1	-2	23	3
Yields and Spreads					bps		
US 10y Yield		1.30	2.1	1	-19	72	39
Germany 10y Yield		-0.40	2.8	-5	-22	8	17
EMBIG Sovereign Spread		355	3	5	17	-88	4
FX / Commodities / Volatility					%		
EM FX vs. USD, (+) = appreciation		56.4	-0.1	0	-2	1	-3
Dollar index, (+) = $ appreciation		93.0	0.1	0	1	-2	3
Brent Crude Oil ($/barrel)		73.7	-0.1	0	-2	70	42
VIX Index (%, change in pp)		17.1	-0.6	-1	1	-9	-6

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

Mature Markets

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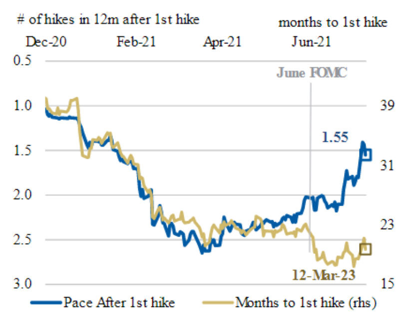
United States

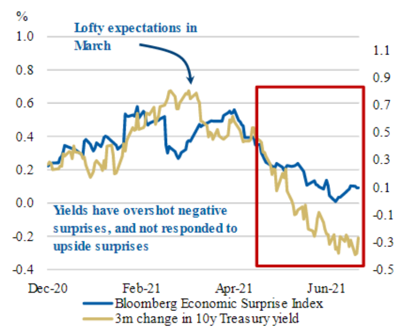
The upcoming FOMC meeting on July 28 could be more consequential that originally expected as low rates and low expectations for future rate hikes could embolden the Fed to act more quickly on tapering. Some analysts think the Fed has been presented with a “gift horse” in the form of lower real and nominal rates since the previous meeting on June 16, which they think could lead the FOMC to become more aggressive in its tapering plans. US equities trading near record highs is another favorable development. Markets are currently pricing the first rate in Q1 2023 and expect less than two full hikes in the following 12 months. Other analysts disagree, pointing out that Treasury yields have dragged down by negative data surprises and have not responded to positive surprises, suggesting that markets are worried about a weaker than expected rebound for the economy. They belive the economy has already hit “peak rebound” and data will begin to slow in the months ahead, staying the Fed’s hands.

Exhibit 4: Market-implied date of Fed liftoff and the implied pace of hikes



Source: Morgan Stanley Research

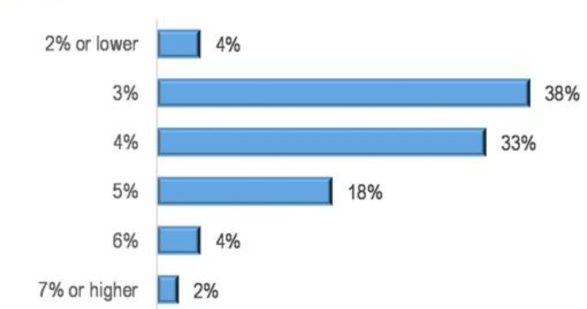
Exhibit 5: 3m change in 10y Treasury yields vs. Bloomberg Economic Surprise Index



Source: Morgan Stanley Research

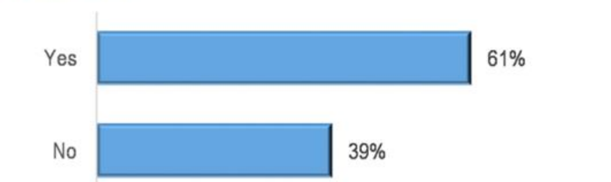
The latest JP Morgan survey finds that investors are relatively confident that US inflation will not be a problem for markets. The great majority (75%) think H2 2021 will see inflation in the 3-4% range or even lower. In addition, a strong majority thinks the ongoing bout of inflation will be temporary. Market pricing appears to endorse this view, as real yields on US Treasury Inflation Protected Securities (TIPS) as well as breakeven yields (nominal yields minus TIPS yields) have fallen significantly. 10-year Treasury yields had fallen as low as 1.13% intra-day on Monday and remain very low. These trends could also account for investors’ bullish sentiment on stocks, as nearly two-thirds of those surveyed said they planned to increase their allocation to equities.

Figure 11: What do you expect the annualized rate of inflation (US core CPI) to be in the 2nd half of this year?



Source: J.P. Morgan.

Figure 12: Is the current high inflation most likely transitory? (assuming monetary policy remains on its current trajectory)

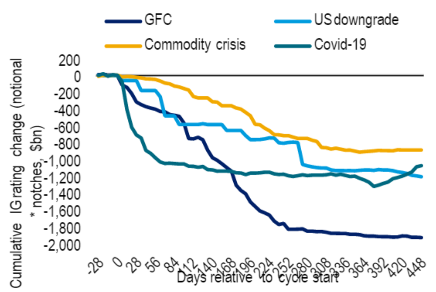


Source: J.P. Morgan.

Figure 13: When do you expect y/y core inflation prints to fall back to 2%?

Bullish sentiment in the US high yield (HY) corporate bond market is reinforced by expectations that many HY companies will be upgraded to investment grade (IG). The pandemic downgrade cycle was second only to the GFC cycle in terms of the number of downgrades. Rating agencies downgraded many IG companies to HY (such companies are known as “fallen angels”) in expectations of higher defaults, but the default rates in the market were much lower than expected. In addition, many of these companies have delivered strong earnings. As a result, a wave of upgrades is expected in the months ahead, leading to many investors snapping up HY bonds in hopes of benefiting from price increases as the bonds are upgraded to IG (such companies are called “rising stars.” Bank of America’s proprietary model predicts large volumes of rising stars in the months ahead.

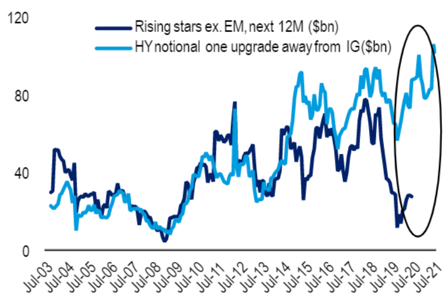
Figure 1: Covid-19 downgrade cycle was only exceeded by the GFC
Cumulative net downgrade volumes for the four past downgrade cycles.



Note: net rating change equals upgrades less downgrades. Based on the average of Moody's, S&P and Fitch, if available. We also include the watch as 2/3 of a notch and the outlook as 1/3 of a notch. Restricted to bonds in ICE BofA IG corporate index C0A0.
Source: BofA Global Research

BofA GLOBAL RESEARCH

Figure 2: Our indicator points to elevated volume of upgrades to IG
HY notional one upgrade away from IG is currently near the highest levels on record.



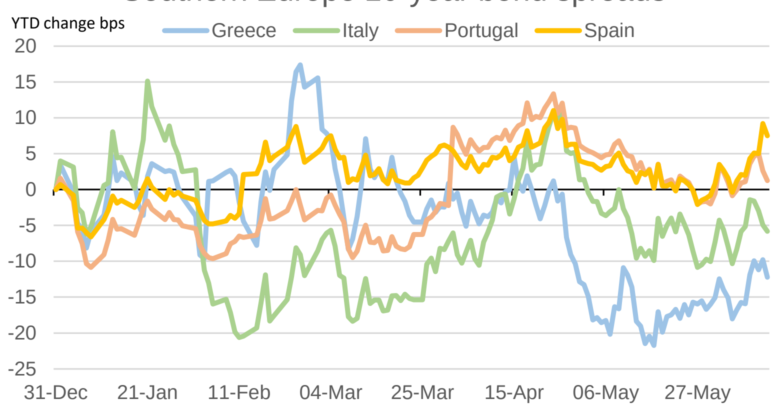
Note: HY notional one upgrade away from IG refers to bonds with one or two BB ratings and one BBB rating, or a single BB rating.
Source: BofA Global Research

BofA GLOBAL RESEARCH

Euro area

European equities gained for the fourth day with most benchmarks up around 0.8%. Technology and automotive sectors were outperforming while shares of French automotive supplier Valeo (+8%) and the British telecommunications firm Vodafone (+3%) jumped on higher earnings results. **In the fixed income space**, German’s 10-year bund yield was up 2 bps while Southern European spreads tightened by around 2 bps.

Southern Europe 10-year bond spreads

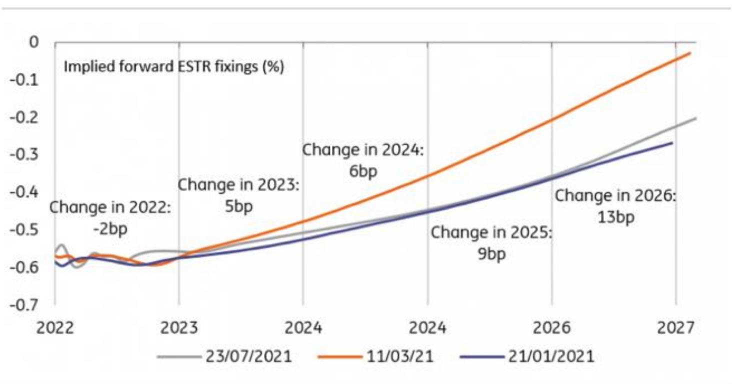


Source: Bloomberg, IMF

Despite the lack of actual policy announcements at yesterday’s ECB meeting, the change in the forward guidance as well as subsequent press-conference comments by President Lagarde, triggered some revisions to analysts’ expectations around ECB’s policy direction. First, there seems to be a greater confidence among analysts that the first rate hike will not come before 2024, which is also roughly in line with current market pricing. Second, several analysts have shifted their Pandemic

Emergency Purchase Program (PEPP) tapering expectations to December from the earlier consensus of September. Some analysts have also noted higher likelihood of extension of the PEPP beyond March 2022 or, alternatively, adoptions of a more sizable post-pandemic asset purchase program.

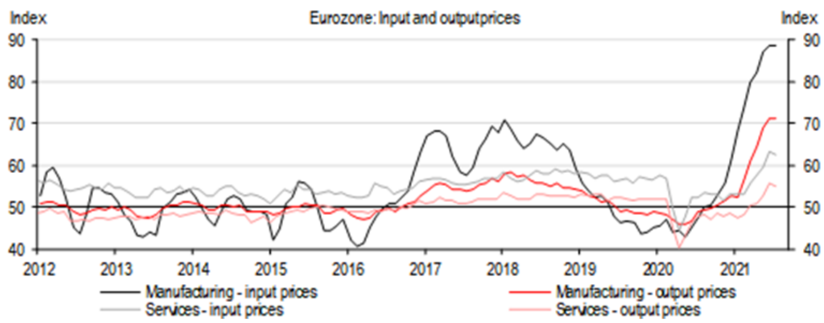
ESTR swaps have priced out the hikes they were expecting a few months ago



Source: Refinitiv, ING

Euro area preliminary July PMI surprised to the upside and hit a 21-year high, with the composite rising to 60.6 (60 expected) as the service sector gained further momentum in Germany, where overall PMI gauge increased to 62.5 from 60.1 in June. France PMI readings surprised somewhat to the downside but continued to point to a strong expansion. The surveys also revealed a further increase in manufacturing backlogs amid shortages of materials and transportation delays. Higher input cost also led to a large increase in average selling prices.

Chart 3: ...and the price indices remain extremely elevated



Source: Refinitiv Datastream, HSBC

United Kingdom

The UK data was somewhat mixed this morning with PMI reading cooling off in July (composite 57.7 vs 62.2 in June). Firms reported material and staff shortages, relating to the Covid-19 driven staff isolations. The delta variant also affected business optimism. By contrast, retail sales growth was surprisingly strong in June, although the statistics office noted potential one-off Euro 2020 football tournament effects.

Emerging Markets back to top

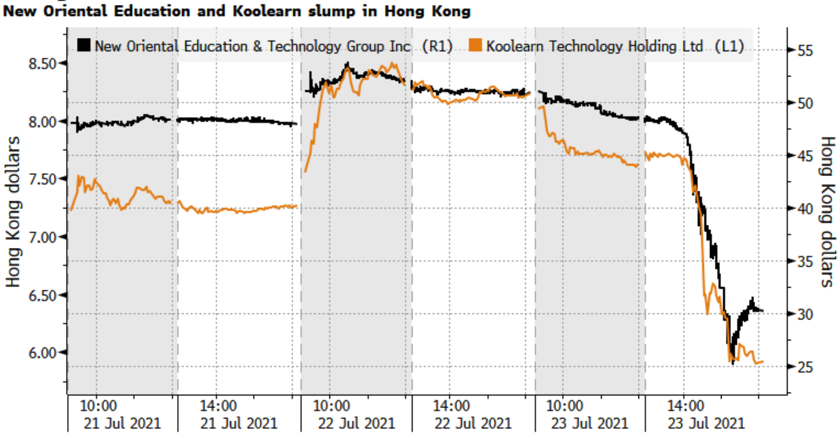
Most emerging markets were higher, with China among the notable exceptions. Paraguay's central bank kept its benchmark rate unchanged at 0.75% and signaled it would start to tighten monetary policy soon. Costa Rica's central bank held the lending rate unchanged at 0.75% yesterday. **The South African Reserve Bank left rates unchanged yesterday and lowered its rate hike expectations for 2021.** The SARB's implied policy rate path shows the policy rate at 3.79% by end 2021, compared to 4.07% at the previous meeting. The central bank acknowledged the recent rise in BER inflation expectations and upside risks to the medium-term inflation outlook. Respondents to the BER survey expect inflation to edge up from 4.2% in 2021 to 4.4% in 2022 and 4.5% in 2023. Analysts have downgraded their growth outlook for 2021 following recent riots.

China and Hong Kong SAR

Chinese equities declined (CSI 300: -1.2%; Hang Seng China Enterprises: -1.7%), with market sentiment souring owing to the risks of further regulatory clampdowns in various sectors and tighter control on property sector financing. Chinese regulators reportedly considered serious penalties for Didi for its decision to go public without consent from cybersecurity regulators. Separately, the People's Bank of China said that it will continue building a long-term system to manage the real estate sector while noting that loans to property developers and mortgage borrowers have slowed this year. Evergrande's share price dropped 7% today, suggesting that the recent sell-off episode is far from over. Meanwhile, **Hong Kong Monetary Authority expressed its concerns to Hong Kong-based banks that have refused to offer mortgage loans for the uncompleted properties developed by Evergrande.**

Chinese authorities are reportedly considering asking tutoring firms to go non-profit. In rules currently being drafted (and not publicly disclosed), education tech firms will no longer be allowed to raise capital or go public. Listed firms will no longer be allowed to invest in education firms. Local regulators will also stop approving new after-school education firms. In China, the education tech industry has emerged as one of the hottest investment plays in recent years, with $10 bn of venture capital funds pouring into the sector last year alone. Big tech firms like Alibaba and Tencent also entered the market. These potential rules are being prepared by a dedicated division created within the Ministry of Education last month to oversee all private education platforms. Share prices of education tech firms fell sharply in Hong Kong (New Oriental Education: -41%; Koolearn: -28%). Analysts expect US-listed Chinese education stocks will similarly decline.

Diving Shares
New Oriental Education and Koolearn slump in Hong Kong



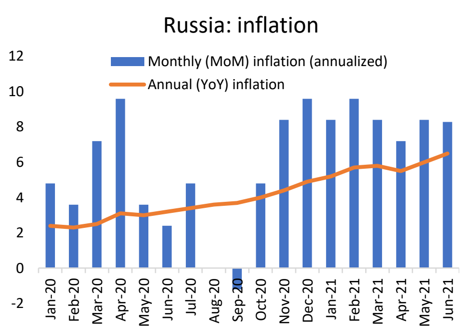
Source: Bloomberg news

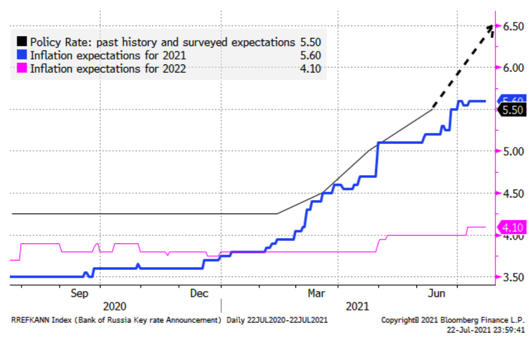
Mexico

Mexico's consumer prices unexpectedly accelerated in the first half of July, increasing the probability of another rate hike in August. Bi-weekly inflation printed at 5.75% y/y, higher than market expectations of 5.65% y/y. The upside surprise in core inflation was mainly driven by food and non-housing and education services. Barclays's analysts revised up their 2021 year-end inflation forecast to 6.0% y/y (5.6% y/y before), while Itaú's analysts predict Mexico's inflation will hit this year at 5.7% y/y but with an upward bias. Mexico's central bank surprisingly hiked its policy rate by 25 bps to 4.25% in the last meeting, and economists expected the Banxico to deliver another rate-hike of 25 bps in August.

Russia

The Central Bank of Russia (CBR) increases its policy rate 100 bps to 6.5% to combat mounting inflation. Core inflation (yoy) has persistently increased since the end of 2020. The central bank has now increased rates by a total of 225 bps. The CBR warned that upside risks to inflation remain and it is considering a rate hike at one of the next meetings. However, expectations for 2022 remain around the CBR inflation target (4%) – thus, implying that medium-term expectations remain anchored. Similarly, the interest rate swaps' priced-in path of the policy rate suggests that the hike is only temporary, and inflation is expected to moderate.





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Global Financial Indicators

Last updated: 7/23/21 8:07 AM	Level: Last 12m	Level: Latest	Change: 1 Day	Change: 7 Days	Change: 30 Days	Change: 12 M	YTD
Equities					%		%
United States		4375	0.2	1	3	35	16
Europe		4101	1.0	2	1	22	15
Japan		27548	0.6	-4	-5	21	0
China		3550	-0.7	0	-2	11	2
Asia Ex Japan		91	0.2	-1	-2	23	2
Emerging Markets		53	0.2	-1	-2	23	3
Interest Rates					basis points		
US 10y Yield		1.30	2.1	1	-19	72	39
Germany 10y Yield		-0.40	2.8	-5	-22	8	17
Japan 10y Yield		0.02	0.0	-1	-4	0	0
UK 10y Yield		0.61	3.9	-2	-18	48	41
Credit Spreads					basis points		
US Investment Grade		91	-0.6	-1	0	-39	-4
US High Yield		331	-1.3	4	10	-220	-49
Europe IG		47	-0.6	-1	0	-11	-1
Europe HY		234	-1.9	-4	3	-107	-8
Exchange Rates					%		
USD/Majors		92.95	0.1	0	1	-2	3
EUR/USD		1.18	0.0	0	-1	1	-4
USD/JPY		110.6	0.4	0	0	3	7
EM/USD		56.4	-0.1	0	-2	1	-3
Commodities					%		
Brent Crude Oil ($/barrel)		74	-0.1	0	-2	70	42
Industrials Metals (index)		158	1.1	1	3	41	19
Agriculture (index)		59	0.9	2	7	63	22
Implied Volatility					%		
VIX Index (%, change in pp)		17.1	-0.6	-1.4	0.8	-9.0	-5.7
US 10y Swaption Volatility		77.7	0.3	8.2	10.8	25.6	17.6
Global FX Volatility		6.8	0.0	0.1	0.0	-0.7	-1.3
EA Sovereign Spreads					10-Year spread vs. Germany (bps)		
Greece		107	-3.0	3	5	-48	-13
Italy		104	-1.9	-2	-3	-42	-7
Portugal		61	-1.6	0	0	-20	1
Spain		69	-2.2	5	6	-11	7

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

Emerging Market Financial Indicators

Last updated: 7/23/2021 8:09 AM	Exchange Rates							Local Currency Bond Yields (GBI EM)					
	Level		Change (in %)					Level		Change (in basis points)			
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	Last 12m	Latest	7 Days	30 Days	12 M	YTD
		vs. USD	(+) = EM appreciation						% p.a.				
China		6.48	-0.1	0.0	0	8	1		3.1	-3	-17	2	-21
Indonesia		14493	-0.1	0.0	0	1	-3		6.3	-3	-19	-71	21
India		74	0.1	0.2	0	0	-2		6.4	-1	7	53	50
Philippines		50	-0.4	-0.2	-3	-2	-5		4.4	6	14	60	72
Thailand		33	-0.2	-0.4	-3	-4	-9		1.7	-5	-17	27	35
Malaysia		4.23	-0.1	-0.5	-2	1	-5		3.2	-4	-7	72	65
Argentina		96	0.0	-0.2	-1	-26	-13		44.6	28	-15	-112	-1153
Brazil		5.19	0.2	-1.5	-4	0	0		8.3	-11	-12	304	274
Chile		754	-0.3	0.5	-2	2	-6		4.3	-2	5	158	152
Colombia		3870	-0.4	-1.4	-3	-6	-11		6.7	-4	5	147	163
Mexico		20.09	0.2	-1.0	1	12	-1		7.0	9	14	110	141
Peru		3.9	0.3	0.3	1	-11	-8		5.4	-18	-13	138	183
Uruguay		44	0.2	0.2	0	-3	-3		7.9	3	0	-160	65
Hungary		305	-0.5	-0.3	-4	-2	-3		2.2	-6	-11	76	70
Poland		3.88	-0.1	0.0	-2	-2	-4		1.1	-12	-21	27	43
Romania		4.2	0.0	-0.2	-1	0	-5		3.0	1	25	-74	27
Russia		73.6	0.1	0.6	-1	-3	1		6.8	-18	-10	143	111
South Africa		14.8	-0.6	-2.3	-4	13	-1		9.9	10	9	-22	25
Turkey		8.55	0.2	-0.2	1	-20	-13		17.6	13	-7	630	446
US (DXY; 5y UST)		93	0.1	0.3	1	-2	3		0.73	-4	-15	46	37

	Equity Markets							Bond Spreads on USD Debt (EMBIG)					
	Level		Change (in %)					Level		Change (in basis points)			
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	Last 12m	Latest	7 Days	30 Days	12 M	YTD
								basis points					
China		5089	-1.2	0	-3	13	-2		212	3	7	-25	-17
Indonesia		6102	-0.6	1	1	20	2		186	4	12	-72	-14
India		52976	0.3	0	0	39	11		156	6	11	-84	5
Philippines		6521	-0.8	-3	-6	9	-9		116	3	20	-33	4
Malaysia		1523	-0.3	0	-2	-4	-6		140	7	15	-48	5
Argentina		65675	-0.2	3	-1	36	28		1581	2	62	-656	225
Brazil		126147	0.2	-1	-2	23	6		281	4	29	-64	22
Chile		4288	0.0	3	-2	8	3		155	3	7	-49	-1
Colombia		1252	0.1	-2	0	6	-13		276	4	20	16	61
Mexico		50241	0.4	0	0	34	14		356	5	20	-125	-1
Peru		18760	0.1	1	0	9	-10		169	7	3	-3	40
Hungary		47413	-0.7	-1	-2	33	13		142	0	5	-41	-7
Poland		67011	0.2	0	0	29	18		36	-1	-1	-3	8
Romania		11902	0.0	-1	3	39	21		194	3	12	-86	-9
Russia		3753	0.0	0	-2	32	14		182	2	12	-44	3
South Africa		68077	1.0	2	3	21	15		347	7	23	-172	-37
Turkey		1352	0.0	-2	-3	13	-8		478	8	15	-116	31
Ukraine		525	0.0	0	-1	5	5		515	11	7	-122	22
EM total		53	-0.7	-1	-2	23	3		369	4	14	-42	31

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

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