GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

Global Markets Monitor

THURSDAY, SEPTEMBER 1, 2022

- **Treasury liquidity declined to what was seen in Q1-2020** (link)
- **European markets betting that the ECB will hike 75 bps next week** (link)
- **Italian spreads close to levels that triggered the creation of the TPI in June** (link)
- **Manufacturing PMIs in the euro area signal contraction** (link)
- **Chinese equities declined as Chengdu will be placed under lockdown** (link)
- **Mexico's central banks cuts 2023 growth forecast** (link)
- **Special feature: Emerging Market Local Currency Bond Monitor (attached)**

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Unease over central bank tightening continues to weigh on markets

Markets appear poised to continue the string of losses as investors are becoming increasingly cautious of decisive moves by major central banks, and China instituted a lockdown in its fifth largest city. European equities are more than 1% lower so far this morning, and futures on the S&P 500 are indicating a fifth straight day of negative returns is likely. Following yesterday's higher than expected inflation release in Europe, more analysts now expect the ECB to raise rates by 75 bps at next week's meeting, with each statement by ECB officials being watched closely. Meanwhile markets continue to price a high likelihood of a similar move by the US Fed later this month. Short-dated treasury yields though are slightly lower today with the 2-year yield down 2 bps, after reaching its highest level in nearly 15 years yesterday.

Key Global Financial Indicators

Last updated: 9/1/22 8:06 AM	Level: Last 12m	Level: Latest	Change from Market Close: 1 Day	7 Days	30 Days	12 M	YTD	Since 23-Feb-22
Equities				%			%	
S&P 500		3955	-0.8	-4	-4	-13	-17	-6
Eurostoxx 50		3482	-1.0	-5	-6	-18	-19	-12
Nikkei 225		27661	-1.5	-3	0	-3	-4	5
MSCI EM		39	0.4	-1	0	-26	-19	-17
Yields and Spreads				bps				
US 10y Yield		3.19	0.0	17	62	190	168	120
Germany 10y Yield		1.56	2.3	25	79	194	174	134
EMBIG Sovereign Spread		501	1	16	-31	159	134	88
FX / Commodities / Volatility				%				
EM FX vs. USD, (+) = appreciation		50.1	0.1	0	-1	-12	-5	-6
Dollar index, (+) = $ appreciation		109.1	0.4	1	3	18	14	13
Brent Crude Oil ($/barrel)		94.2	-1.5	-5	-6	32	21	-3
VIX Index (%, change in pp)		26.5	0.6	5	4	10	9	-5

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

Mature Markets

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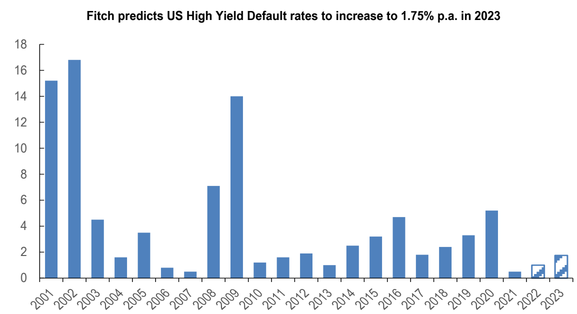
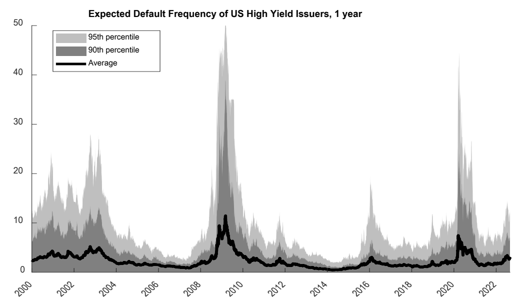
United States

Rating agencies expect a milder recession than credit spreads imply. Fitch analysts estimate that following the burst of the Dotcom bubble in 2001 and 2002 as well as the Global Financial Crisis in 2009, the default rate of US High Yield issuers rose above 15%. While they forecast that the default rate will pick up again, it won't be much, rising from 0.5% in 2021 to 1.0% in 2022 and 1.75% in 2023 (left chart below). This benign view is challenged by pricing of credit spreads for US high yield issuers. Holding recovery rates constant and adjusting for risk premia, the market-implied expected default frequency for US high yield issuers currently averages 3%, which is about twice the Fitch estimate for 2023. Moreover, the company-level aggregation of the US high yield market is also instructive as it allows looking at the evolution of default rates among distressed issuers. The expected default frequency of these issuers has risen to 15% ahead of the July FOMC meeting and is likely to return to comparable levels after Chair Powell's hawkish reiteration last Friday. Past recessions saw an expected default rate of distressed issuers above 40%. This suggests that the market pricing anticipates a relatively mild recession by historical standards, but one that is perceived to be more severe than what rating analysts expect.

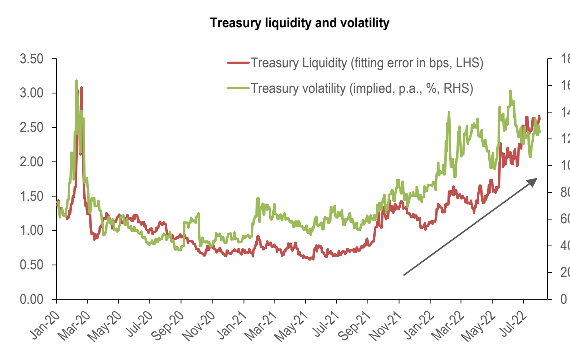


Source: Fitch

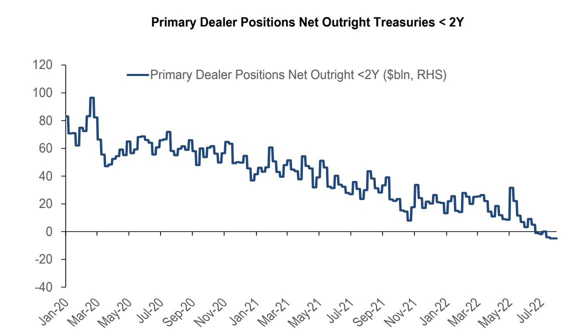


Source: IMF staff calculations, Moody's CreditEdge

Treasury liquidity declined to levels last seen during the outbreak of the Covid-19 pandemic. Although liquidity is inherently an elusive latent driver of markets, there are approximations that gauge market liquidity at any given point in time. One such approximation which is inversely related to liquidity are yield curve spline fitting errors: when liquidity is abundant, market participants are expected to exploit the bond mispricing, so that yield curve errors should quickly disappear. Conversely, when liquidity is scarce, market participants are apprehensive to capitalize on the mispricing, so that it persists. Recently, these yield curve errors rose to levels previously seen during the outbreak of the pandemic, which market contacts see connected with the increase of Treasury volatility (see left chart below). Aside from fixed income relative value hedge funds (which we wrote about in yesterday's GMM) primary dealers' net outright positioning has also declined, particularly in nominal Treasuries with maturities below 2 years (right chart below).



Source: IMF staff calculations, Bloomberg



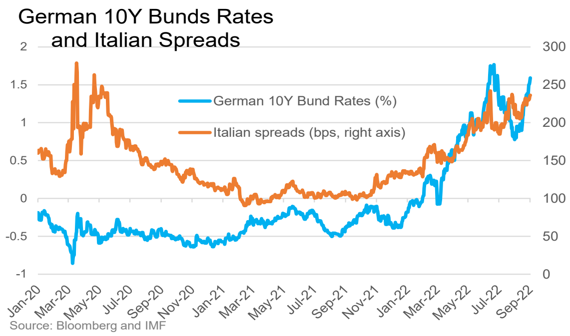
Source: IMF staff calculations, Bloomberg

Euro Area

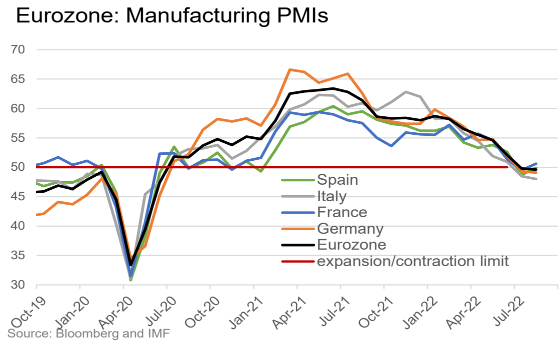
European markets are in a risk-off mood this morning: stock markets are down, currencies are depreciating, and bond yields and southern European spreads are going up. Equity markets are down across the board in Europe, with the Stoxx Europe 600 and the UK FTSE 100 each losing 1.4%. The Euro is hovering around parity, losing 0.3% to the US dollar, and the British pound is losing 0.2% to 1.16 $/£) close to its pandemic lows. German 10Y bund yields are up 5 bps, at 1.58%, and Italian spreads reached 236 bps, close to their mid-June high, which prompted the ECB to announce its new anti-fragmentation tool. After yesterday's inflation data for the Euro area in August surprised markets slightly to the upside (9.1% y/y up from 8.9% in July), market participants continue to focus on interventions from ECB officials to assess whether the ECB will hike 50 or 75 bps at its next meeting on September 8. Most bank analysts changed their calls for a 75 bps hike rather than 50 bps yesterday.

European markets are focused on whether the ECB will hike 50 or 75 bps at its next meeting on September 8. After the release of inflation data for the Euro area in August yesterday surprised markets slightly to the upside at 9.1% (vs 9% expected), analysts at several banks, including JP Morgan, Goldman Sachs, Bank of America, and Morgan Stanley revised their rate hike call for ECB's next meeting to 75 bps. Market participants also continue to table the number of hawkish vs. more dovish recent statements from ECB officials ahead of the meeting to assess the probability of a 75 bps hike. Since Jackson Hole, they count six hawkish interventions (Isabel Schnabel, ECB executive board member, and from the central bank governors of the Netherlands, Austria, Latvia, Estonia, and Germany), while the recent statement from the ECB's chief economist Philip Lane, who argued for a series of calibrated steps rather than a smaller number of larger hikes is seen as backing a 50 bps hike. Yesterday, French central bank governor Villeroy de Galhau said that the ECB should show determination with interest-rate increases while also acting in an orderly and predictable way. He added that he did not see evidence of a wage-price spiral.

Markets are starting to notice that Italian spreads are close to their mid-June levels (236 bps vs 239 in mid-June), which prompted the ECB to announce its new anti-fragmentation tool, the Transmission Protection Instrument (TPI) at an emergency meeting of the Governing Council in June. Italian 10y yields went briefly above 4% this morning for the first time since June 15.



Manufacturing PMI for August in the euro area came in at 49.6, close to expectations (49.7) this morning and did not move markets significantly. This was unchanged from July, and the second consecutive reading below 50, which signify a contraction in manufacturing output. PMI readings were better than anticipated in France (50.6 vs 49 expected) and Spain (49.9 vs 48.5 expected), at the cusp of contraction levels and higher than in July. Italy's reading met expectations at 48, slowing from 48.5 in July. Germany's reading at 49.1 was worse than expected (49.8), and down from July.



Japan

The Japanese yen depreciated (-0.2%), touching 139.2 yen per dollar, the weakest level in 24 years. Markets increasingly focused on a further divergence of interest rates between Japan and other major advanced economies. Long-end JGB yields rose (10-year: +1.7 bps; 30-year: +3.5 bps), with the 10-year yield edging up to 0.237%. Japanese equities declined (NIKKEI: -1.5%), broadly similar to the regional trend. **Manufacturing PMI improved to 51.5 in August from 51.0 in July.** Businesses increased capital spending by 4.6% y/y in 2022Q2, while corporate profits improved 17.6% y/y; both better than expectations.

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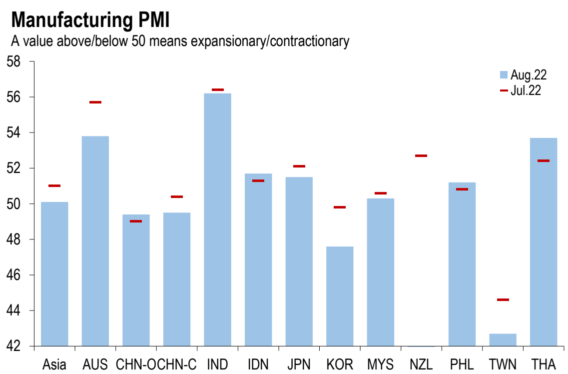
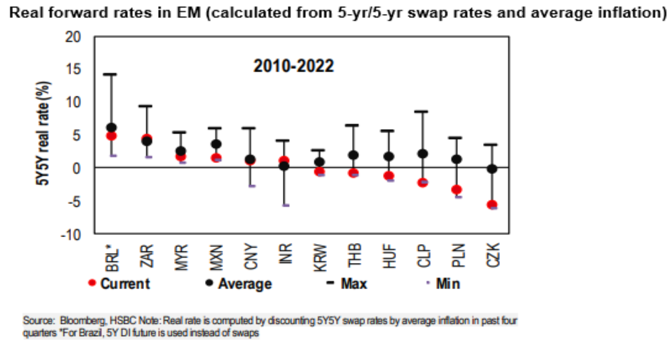


Asian equities declined, falling 2.2% on net, led by Taiwan (-1.9%), and Hong Kong (-1.8%). August Manufacturing PMI deteriorated notably in Taiwan Province of China. Asian currencies depreciated, led by the Thai baht (-0.7%) and Taiwan dollar (-0.5%). Long-end government bond yields generally increased, with 10-year yields rising in Singapore (+7 bps), Philippines (+5 bps), and Thailand (+4 bps), following the rise in US treasury yields. In Indonesia, headline CPI inflation moderated to 4.7% y/y in August from 4.9% in July (consensus: +4.9%), while core CPI inflation edged up to 3.0%; Indonesian rupiah depreciated (-0.3%). In Sri Lanka, the government reached a staff-level agreement with the IMF for a $2.9 bn loan under a 48-month program. Sri Lankan rupee appreciated (+0.2%), while equities gained (+2.0%). **EMEA Equities fell in line with global markets,** with the sharpest losses in South Africa (-1.9%) and Poland (-1.8%). Turkish bank equities (+3%) continue to gain sharply as analysts write that domestic investors have been purchasing bank stocks as protection against inflation, with foreign investors reducing exposure. The South African rand fell 0.4% even as the ABSA manufacturing PMI was materially better than expected at 52.1 in August (48.3 expected). **Local rates are generally higher across the region.** LatAm markets continued to slide on Wednesday. Equities registered strong losses with markets in Colombia (-3.3%), Mexico (-2.2%), and Argentina (-3.5%) bearing the heaviest losses. Brazil, Chile, and Peru too closed lower in the range of 0.8-1.6%. Most currencies saw modest declines against the USD, however, the Brazilian real (-1.2%) and the Chilean peso (1.1%) were the outliers here.

Inflation-adjusted forward rates across emerging markets

Analysts at HSBC argue that forward rates adjusted for inflation remain relatively low in Central and Eastern Europe and argue that a “real rate cushion” is sizeable only in a few EM countries such as Brazil, South Africa, Malaysia, and Mexico.

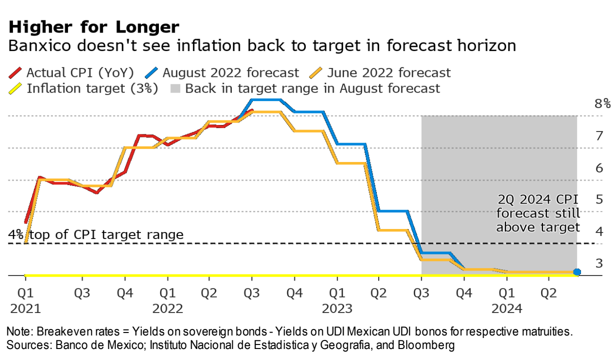


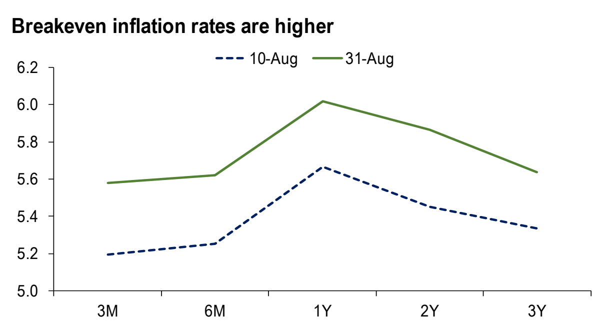
China

Chinese equities declined (CSI 300: -0.9%; Hong Kong SAR-listed: -1.8%) as Chengdu, the fifth largest city of 21 mn people in southwest China, will be placed under lockdowns. **Caixin PMI deteriorated to 49.5 in August from 50.4 in July,** weaker than expected (consensus: 50.0). RMB depreciated (-0.1%) as the People's Bank of China continued to lean against RMB depreciation. Today's RMB fixing was stronger than expected by 103 pips. Long-end government bond yields declined (10-year: -1 bps; 30-year: -1 bp), contrasting the regional trend that saw rising bond yields. Interbank liquidity remained flush, with the key interbank repo rate (DR007) falling to 1.43% (-29 bps). Home sales of major 100 property developers declined 32.9% y/y in August. Analysts noted that the real estate sector is far from a rebound due to the weak economic outlook.

Mexico

The central bank of Mexico (Banxico) revised growth forecasts downwards while maintaining recent inflation forecasts. In its quarterly report, Banxico revised its 2023 growth forecast downwards by 80 bps to 1.6% citing lower-than-expected external demand. Notably, the recovery in domestic demand is expected to stay on the course, but the country's ongoing dispute with US and Canada under the trade agreement (USMCA) is identified as a potential downside risk. On inflation, Banxico maintained its August 11 estimates but sounded vigilant of the policy rate decisions of the Fed, domestic inflation expectations, and volatility in domestic financial markets. As per a Morgan Stanley report, given the persistetly high inflation, Banxico is expected to raise the policy rates by 75 bps in the September meeting, with a terminal rate of 10.25% beyond that, which would also be contingent on inflation expecation survey results, and the US Fed's policy path.





Russia

The ruble (+1%) is little changed following reports that Russia is considering a plan to buy up to $70 bn in yuan and other "friendly" currencies in 2022 to slow the ruble's surge. According to Bloomberg, the plan won initial support at a special "strategic" planning meeting of top government and central bank officials including governor Nabiullina on August 30, 2022.

This monitor is prepared under the guidance of Ranjit Singh (Assistant Director), Nassira Abbas (Deputy Division Chief), Charles Cohen (Deputy Division Chief), and Antonio Garcia-Pascual (Deputy Division Chief). Fabio Cortes (Senior Economist), Reinout De Bock (Senior Economist-London Representative), Sanjay Hazarika (Senior Financial Sector Expert), Esti Kemp (Financial Sector Expert-London Pepresentative), Tom Piontek (Senior Financial Sector Expert) and Jeff Williams (Senior Financial Sector Expert) are the lead editors of this monitor. The contributors are Yingyuan Chen (Financial Sector Expert), Mohamed Diaby (Economist, EP), Deepali Gautam (Research Officer), Frank Hespeler (Senior Financial Sector Expert), Shoko Ikarashi (Externally Financed Appointee), Phakawa Jeasakul (IMF Resident Representative in Hong Kong SAR), Johannes S Kramer (New York Representative), Aurelie Martin (Senior Economist- London Representative), Kleopatra Nikolaou (Senior Financial Sector Expert), Natalia Novikova (IMF Resident Representative in Singapore), Silvia Ramirez (Senior Financial Sector Expert), Patrick Schneider (Financial Sector Expert), Dmitry Yakovlev (Senior Research Officer), Akihiko Yokoyama (Senior Financial Sector Expert), and Xingmi Zheng (Research Assistant). Javier Chang (Senior Administrative Assistant) Olga Lefebvre (Staff Assistant), and Srujana Sammeta (Staff Assistant) are responsible for the word processing and production of this monitor.

Global Financial Indicators

	Level		Change					Since
9/1/22 8:06 AM	**Last 12m**	**Latest**	**1 Day**	**7 Days**	**30 Days**	**12 M**	**YTD**	**23-Feb-22**
Equities					%		%	%
United States		3948	-0.8	-6	-4	-13	-17	-7
Europe		3482	-1.0	-5	-6	-18	-19	-12
Japan		27661	-1.5	-3	0	-3	-4	5
China		4044	-0.9	-2	-2	-17	-18	-13
Asia Ex Japan		67	0.9	0	-1	-25	-19	-15
Emerging Markets		39	0.4	-1	0	-26	-19	-17
Interest Rates					basis points			
US 10y Yield		3.19	0.0	17	62	190	168	120
Germany 10y Yield		1.56	2.3	25	79	194	174	134
Japan 10y Yield		0.24	1.6	1	6	21	17	5
UK 10y Yield		2.84	4.1	23	103	215	187	136
Credit Spreads					basis points			
US Investment Grade		165	1.4	8	-4	73	53	22
US High Yield		516	5.3	35	13	195	178	109
Europe IG		120	0.9	13	19	76	73	49
Europe HY		587	-1.3	57	76	361	345	235
Exchange Rates					%			
USD/Majors		109.11	0.4	1	3	18	14	13
EUR/USD		1.00	-0.5	0	-3	-15	-12	-12
USD/JPY		139.2	0.2	2	6	27	21	21
EM/USD		50.1	0.1	0	-1	-12	-5	-6
Commodities					%			
Brent Crude Oil ($/barrel)		94	-1.5	-4	-4	41	28	8
Industrials Metals (index)		148	-3.6	-7	-6	-8	-14	-21
Agriculture (index)		68	-1.1	0	5	21	13	-3
Implied Volatility					%			
VIX Index (%, change in pp)		26.5	0.6	4.7	3.7	10.4	9.3	-4.5
US 10y Swaption Volatility		124.3	-2.2	-2.8	8.7	52.7	45.3	30.0
Global FX Volatility		11.0	0.0	-0.1	0.2	4.3	3.5	3.5
EA Sovereign Spreads					10-Year spread vs. Germany (bps)			
Greece		263	6.7	5	51	148	112	23
Italy		238	3.1	14	27	132	103	67
Portugal		109	0.7	3	9	51	45	18
Spain		120	0.7	3	12	49	46	17

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

Emerging Market Financial Indicators

Last updated: 9/1/2022 8:07 AM	Exchange Rates								Local Currency Bond Yields (GBI EM)							
	Level		Change (in %)					Since	Level		Change (in basis points)					Since
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	23-Feb-22	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	23-Feb-22
		vs. USD	(+) = EM appreciation							% p.a.						
China		6.90	-0.1	-0.7	-2	-6	-8	-8		2.7	-2.0	-6	-11	-23	-14	-15
Indonesia		14883	-0.3	-0.4	0	-4	-4	-4		7.1	0.7	7	1	105	75	64
India		80	-0.1	0.4	-1	-8	-7	-6		7.6	7.1	3	26	106.3	125	
Philippines		56	-0.5	-0.7	-2	-11	-10	-9		5.5	0.0	23	8	185	100	50
Thailand		37	-0.3	-2.3	-2	-12	-9	-12		2.8	12.0	25	46	126	98	60
Malaysia		4.48	-0.2	-0.3	-1	-7	-7	-7		4.0	3.4	5	13	82	43	35
Argentina		139	-0.1	-1.1	-5	-30	-26	-23		77.3	-44.8	166	1223	3100	2670	2930
Brazil		5.21	-0.6	-2.0	-1	-1	7	-4		12.2	11.4	2	-52	159	149	65
Chile		896	-1.1	2.8	0	-14	-5	-12		6.5	0.0	-16	12	180	110	61
Colombia		4427	-0.2	-0.5	-4	-15	-8	-12		9.5	0.0	20	86	369	311	164
Mexico		20.17	-0.2	-1.2	1	-1	2	0		8.7	-4.5	12	66	182	121	89
Peru		3.9	-0.7	0.4	1	6	4	-3		8.0	0.3	8	6	180	213	203
Uruguay		41	-0.3	-1.2	0	4	9	4		11.2	20.4	34	23	330	247	305
Hungary		399	-0.2	3.3	-2	-26	-19	-20		9.5	12.5	24	115	652	495	465
Poland		4.71	-0.2	0.9	-2	-19	-14	-14		6.2	-3.5	12	101	440	269	232
Romania		4.8	-0.6	0.7	-1	-14	-10	-10		7.7	-1.7	-25	-40	429	287	254
Russia		60.4	0.9	0.0	2	21	24	35		8.3	-30.0	0	1	96	-52	-293
South Africa		17.1	-0.1	-2.2	-4	-16	-7	-12		9.1	6.0	25	22	190	162	146
Turkey		18.20	0.0	-0.2	-2	-54	-27	-24		13.0	0.0	-29	-473	-410	-1133	-943
US (DXY; 5y UST)		109	0.4	0.6	3	18	14	13		3.33	-2.1	18	70	256	207	143

	Equity Markets								Bond Spreads on USD Debt (EMBIG)						
	Level		Change (in %)					Since	Level		Change (in basis points)				Since
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	23-Feb-22	Last 12m	Latest	7 Days	30 Days	12 M	YTD	23-Feb-22
									basis points						
China		4044	-0.9	-2	-2	-17	-18	-13		203	-7	-21	-14	0	-5
Indonesia		7153	-0.4	0	2	18	9	3		176	6	-28	-2	11	-9
India		58767	-1.3	-1	1	2	1	3		153	-5	-37	7	21	-1
Philippines		6588	0.1	-1	4	-4	-8	-11		122	5	-20	15	21	-15
Thailand		1622	-1.0	-1	2	-2	-2	-4		0	0	0	0	0	0
Malaysia		1492	-1.3	2	0	-6	-5	-6		91	-19	-46	-41	-26	-42
Argentina		136241	-3.5	-3	16	81	63	49		2394	50	-10	897	714	657
Brazil		109523	-0.8	-3	7	-8	4	-2		311	4	-18	25	0	-20
Chile		5441	-1.7	0	3	22	26	24		185	13	11	43	45	11
Colombia		1228	-3.3	-6	-3	-7	-13	-19		425	23	20	149	77	33
Mexico		44919	-2.2	-5	-5	-14	-16	-13		420	24	0	73	88	50
Peru		18853	-1.6	-4	-1	7	-11	-19		194	13	6	23	44	4
Hungary		41725	-0.4	-4	-1	-20	-18	-13		261	43	46	126	137	108
Poland		49490	-1.4	-7	-11	-30	-29	-21		20	12	8	-9	-12	4
Romania		11932	-1.0	-3	-5	-3	-9	-10		290	13	-31	107	97	57
Russia		2392	-0.4	6	10	-40	-37	-22		3411	-577	938	3228	3234	2897
South Africa		66372	-1.3	-6	-3	-1	-10	-11		441	15	-6	96	86	52
Turkey		3166	-0.2	3	19	115	70	57		657	24	-80	204	79	94
Ukraine		519	0.0	0	0	-1	-1	0		3814	438	-2793	3331	3055	2341
EM total		39	-1.1	-1	0	-26	-19	-17		433	19	-10	83	47	-25

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

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