



- Rising real rates at a 13-year high challenge the valuations of tech stocks ([link](#))
- Kansas City Fed paper suggests that Fed might need to be restrictive for longer ([link](#))
- European markets stabilized somewhat after yesterday's sharp sell-off ([link](#))
- Ongoing Strains in Property Sector Amid Highest Gilt Yields Since 2009 ([link](#))
- Japan's labor cash earning increased stronger than expected ([link](#))
- Banco Central de Chile's minutes suggest looser stance if inflation continues to ease ([link](#))
- Although Hungary's inflation declines, weaker forint challenges further rate cuts ([link](#))
- **Special Feature: EM Capital Flows** (attached)

[Mature Markets](#)

| [Emerging Markets](#)

| [Market Tables](#)

Relief Rally as Non-Farm Payrolls Weaken, Despite Stronger Wage Data

Markets eagerly awaited the release of US jobs report this morning, which has triggered a relief rally as the headline non-farm payrolls release missed expectations with the 2-year yields dipping back below 5%. Beforehand, with rising real rates as the driving force, 2-year yield surpassed 5% and 10-year ones reached its highest level since March, surpassing 4%. Adding to resilient labor market data yesterday morning, an upbeat ISM services PMI later during the day swayed the possibility of another rate hike at the upcoming Fed meeting on July 26. Against this backdrop, the S&P 500 yesterday corrected by -0.8%, with declines throughout all 11 sectors. In Europe, markets have been somewhat more stable today, whereas in Asia, stronger than expected wage gains in Japan prompted the JGB curve to steepen in anticipation that a monetary policy adjustment of the Bank of Japan may come sooner. The Japanese yen appreciated meanwhile Japanese equities have followed their Asian peers in a continued selloff. In the CEE region, market contacts are attentive to the press conference of National Bank of Poland's Governor Adam Glapinski today after the central bank left the policy rate unchanged at its meeting yesterday. Hungarian bond yields sharply corrected as a weaker forint might call into question the anticipation of further rate cuts.

Key Global Financial Indicators

Last updated: 7/7/23 8:57 AM	Level		Change from Market Close				YTD	Since 23-Feb-22
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M		
Equities								
			%				%	
S&P 500		4412	-0.8	1	3	13	15	4
Eurostoxx 50		4243	0.5	-4	-1	22	12	7
Nikkei 225		32388	-1.2	-2	0	22	24	22
MSCI EM		39	-2.0	-1	-1	-3	3	-18
Yields and Spreads								
			bps					
US 10y Yield		4.06	3.5	23	27	107	19	207
Germany 10y Yield		2.65	2.7	26	20	134	8	243
EMBIG Sovereign Spread		428	7	-8	-33	-114	-24	16
FX / Commodities / Volatility								
			%					
EM FX vs. USD, (+) = appreciation		48.5	0.1	-1	-2	-3	-3	-9
Dollar index, (+) = \$ appreciation		102.9	-0.3	0	-1	-4	-1	7
Brent Crude Oil (\$/barrel)		76.7	0.2	2	0	-27	-11	-21
VIX Index (% change in pp)		15.5	0.0	2	2	-11	-6	-16

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

Mature Markets

[back to top](#)

United States

This morning, non-farm payrolls (NFP) missed expectations while wage data came in stronger. The June NFP release printed at 209k (expected 225k from a downward revised 306k). However, wage data printed stronger-than-expected with 0.4% m/m (expected 0.3% from upward revised 0.4%). In an initial reaction, the softer NFP headline release brought a bit of a relief rally with Treasury yields declining -7 bps to 4.95% in the 2-year tenor and by -5 bps to 4.03% in the 10-year tenor, both driven by declining real yields. The USD correspondingly weakened by -0.3% against majors while S&P 500 E-Mini futures gained +0.2%. Notwithstanding this, market contacts note that market pricing might eventually focus on the stronger wage data that will add fuel to the fire and might require further Fed policy restraint.

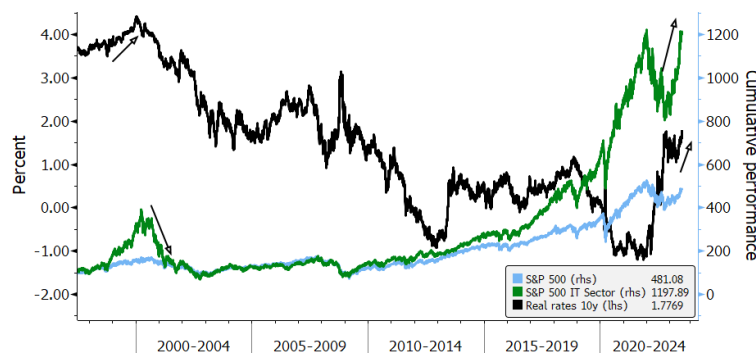
US June Non-Farm Payrolls Report

	Previous Release	Consensus Expectations	Actual Number
Non-farm payrolls	Revised 306k (from 339k)	225k	209k
Unemployment rate	3.7%	3.6%	3.6%
Average hourly earnings m/m	Revised 0.4% (from 0.3%)	0.3%	0.4%
Average hourly earnings y/y	Revised 4.4% (from 4.3%)	4.2%	4.4%
Labor force participation rate	62.6%	62.6%	

Source: Bloomberg

Rising real rates at a 13-year high call into question the sustainability of the tech rally.

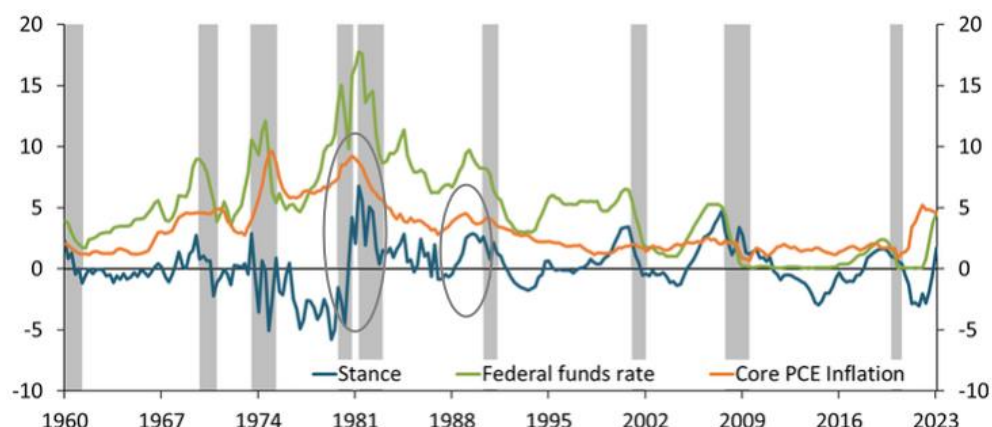
A conundrum lies in the disparity between the rising 10-year real yield, currently standing at 1.69% and the gains observed in the tech sector. Traditionally, rising real yields tend to have a detrimental effect on technology stock multiples as higher yields make future cash flows less valuable, impacting the valuation of growth-oriented companies whose pricing rests on their aspirations for generating cash flows and growth at a more distant point in time. However, the market's ability to maintain gains in the face of rising real rates and persistently high inflation casts doubts on the underlying dynamics at play and suggests that the recent tech rally might be built on shaky grounds as Franklin Templeton analysts note.



A recent publication from the Kansas Fed sends a troubling message for markets. Despite the Fed's aggressive tightening since March 2022 by raising rates by more than 5 pp., the U.S. economy has continued to expand. Kansas Fed staff attribute this phenomenon to rapidly accelerating inflation, which pushed the equilibrium level of interest rates higher at an even faster pace. The report indicates that the natural rate of interest R^* rose at a faster pace, delaying the policy's entrance into restrictive territory until early 2023. A comparison to two historical episodes appears instructive to exemplify the monetary policy stance that the Fed adopted with an explicit intention of bringing down inflation. In 1981 and 1988, the Fed embarked on tightening cycles specifically to bring down inflation, maintaining in both instances a restrictive

monetary policy stance for 12 consecutive quarters which eventually brought down inflation in a noticeable way (see circled areas in chart below). If at this current juncture the Fed would similarly continue keeping a restrictive monetary policy stance for 12 quarters, Kansas Fed staff estimate it could bring down core PCE inflation by 80 bps by end-2026 while the Fed restraint could correspond with a 1.2 pp. cumulative real GDP decline over the next two years. Hence, the Fed might maintain a restrictive stance for longer.

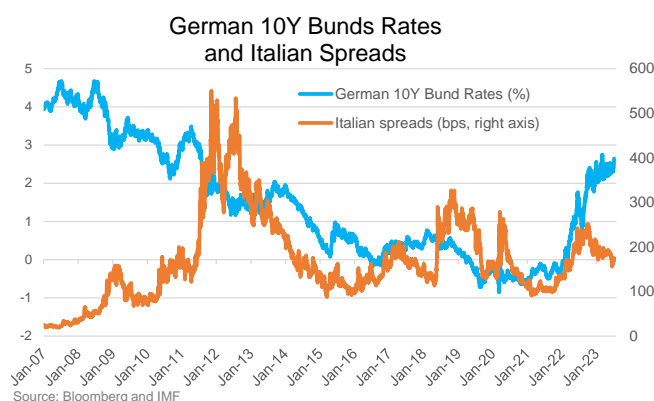
The stance of monetary policy vs. core PCE inflation and nominal Fed Funds



Source: Kansas City Fed, Stance defined as nominal Fed Funds adjusted by inflation expectations and the natural real rate of interest R^*

Euro Area

European markets have somewhat stabilized following yesterday's sharp sell-off. Yesterday, equity market fell -2.3%, and German 10y bund yields increased by +15 bps to 2.62%, their highest levels in more than 15 years. This morning, equity markets in the Euro Area remain flat in the Stoxx Europe 600, while bank stocks recovered +0.6%. The euro remained flat vs. the dollar at 1.09/\$. German 10y bund yields increased by another +2 bps to 2.64% while Italian spreads declined by -2 bps to 173 bps.



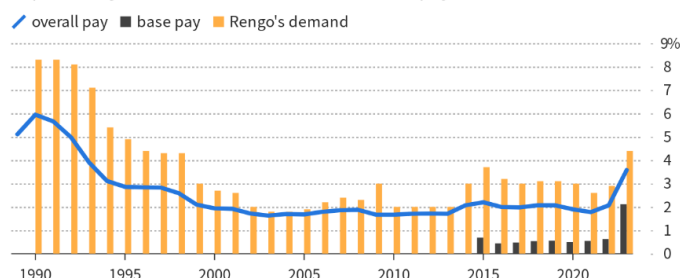
ECB officials emphasize lingering high inflation despite easing trends. This morning, ECB president Lagarde stated in a newspaper interview that despite inflation has started signs of easing, the ECB still has work to do to bring it back down to reach its medium-term inflation target of 2%. She also added that countries need to withdraw support programs that they introduced during the Covid-19 pandemic and the energy crisis, restoring public finances' health. In contrast, ECB board member Luis de Guindos highlighted that while underlying price pressures remain robust, various indicators have begun to show signs of reaching their peak. This suggests to him that the unusually elevated level of uncertainty surrounding the future decline of inflation over the medium term is starting to ease. Mr. De Guindos emphasized the ECB's data dependency, indicating that the decision on policy rates in September remains an open one.

Japan

Upbeat labor cash earnings increased in May. The May data printed at 2.5% y/y (expected +1.2% from 1.0%). According to analysts, the stronger-than-expected data indicated that this spring's wage negotiations finally set off an upward momentum of wage increases. This could strengthen the view that the Bank of Japan may consider a policy adjustment sooner than later. Meanwhile, household spending fell by -4.0% y/y (expected -2.5% from -4.4%) as in real terms, labor cash earnings still declined by -1.2% (expected -2.7% from -3.0%). In reaction, longer-term JGB yields increased, by +1.6bps to up to 0.423% at the 10-year tenor, and by +6.3 bps to 1.268% at the 30-year tenor, which also mirrored the rise in US treasury yields. Meanwhile, the Japanese yen appreciated by +0.4% to 143.5 yen per dollar, outperforming other currencies in the region. Japanese equities declined by -1.2%

Wage Bump

Japan's major labor unions won a historic total pay increase in 2023



Source: Japanese Trade Union Confederation, known as Rengo
Note: Rengo started publishing base-pay data in 2015

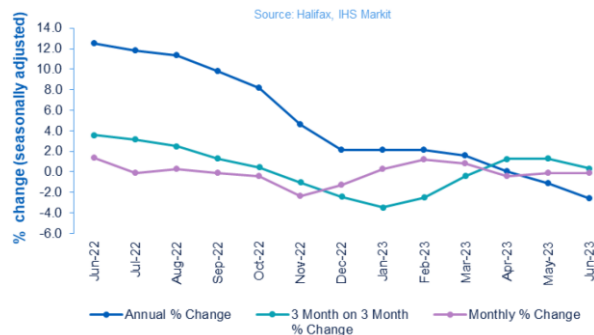
Bloomberg

United Kingdom

The property sector shows ongoing strains amid Gilt yields hitting the highest level since 2009. 10y gilt yields soared +17 bps on the day to 4.66%, their highest level since 2009. This morning, they climbed another +2.6 bps to 4.68%. Market pricing for the BoE's terminal policy rate is for 6.45%, which is +150 bps higher than today's bank rate at 5%. Meanwhile, Halifax warns of ongoing strains in the property market as borrowing costs continue to rise, with average home prices down by -2.6% y/y.

Halifax House Price Index

Source: Halifax, IHS Market



Emerging Markets

[back to top](#)

In Asia, stock markets declined and currencies depreciated. Equities in Philippines -where the May unemployment rate dropped to 4.3% (from 4.5%)- declined by -1.5%, in Korea by -1.2% and in Hong Kong by -0.9%. The Indonesian rupiah (-0.6%), Thai baht (-0.5%), and Korean won (-0.3%) illustrate the weaker currencies against the USD.

Latin American markets traded lower amidst concerns over tighter-for-longer AE monetary policies. Local currency government bond yields traded broadly higher, while equities declined, moving in-tandem with AE markets. Regional currencies depreciated alongside broad USD strength. The Brazilian Real and Mexican Peso led the decline, both down -1.4%, while the Colombian Peso declined by -1.2%.

EMEA saw higher stock markets while currencies weakened. Stock markets in Poland and Hungary outperformed, up +1.1% and +1.0%, while Bulgaria's fractionally declined, down -0.2%. CEE currencies continued weakening against the euro, with the Hungarian forint's depreciation by -0.6% to 387.8/€ leading the decline.

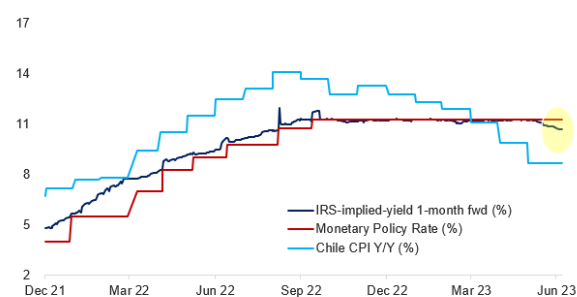
Chile

Banco Central de Chile's June meeting minutes affirmed expectations for less restrictive policy.

Despite that the central bank held its policy rate steady at 11.25% at the last meeting on June 19, the minutes note that the upside risk to inflation is “*balancing out*”, and that the process of reducing policy rates could begin if the “*trend continues*”. One of the two board members backing a 50bps cut at the last meeting stated that the central bank could act now, instead of maintaining the policy rate with a dovish bias, which could be “*interpreted by the market as an anticipation of very aggressive cuts*”.

The market has fully priced in a 50bps policy rate for the upcoming meeting on July 28, driven by the dovish signal. The 1-month interest rate swap implied yield declined by -1bps to 10.69%, defeating the trend of rising global bond yields seen during the trading session.

Markets pricing-in a 50bps cut in policy rate for its next meeting



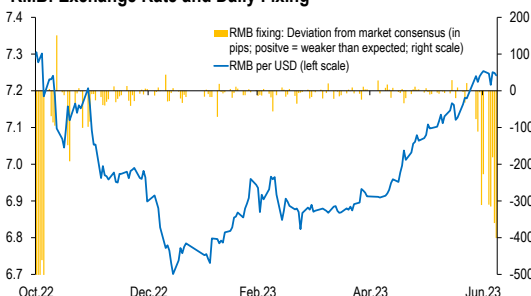
Source: Bloomberg, IMF staff calculation

China

Amid the global risk-off sentiment, Chinese equities continued to decline. The CSI 300 dropped by another -0.4% while Hong Kong SAR-listed shares contracted -1.1%. The decline in Hong Kong SAR-listed shares which the property and tech sectors led by declining -2.3% and -1.4%, respectively. Alibaba shares defy the downtrend, surging +3.7% on a potential end to Ant Group's regulatory probe. According to Reuters, the Chinese authorities will soon announce a fine of at least \$1.1 bn on Ant Group, closing years of the regulatory scrutiny on the digital finance giant. This would allow Ant to seek a financial holding company license, revive its business growth, and eventually start preparing for an IPO.

The People's Bank of China (PBC) continued setting the daily RMB fixing stronger than expected. Today, the deviation of the actual fixing from market expectations further widened to 401 pips. The PBC also continued withdrawing liquidity as quarter-end funding pressures eased. Today, the liquidity withdrawal amounted to 101 bn yuan (\$13.9 bn). CGB yields declined (1-year: -0.2 bp; 10-year: -0.1 bp) while the RMB appreciated to 7.24 (+0.1%).

RMB: Exchange Rate and Daily Fixing

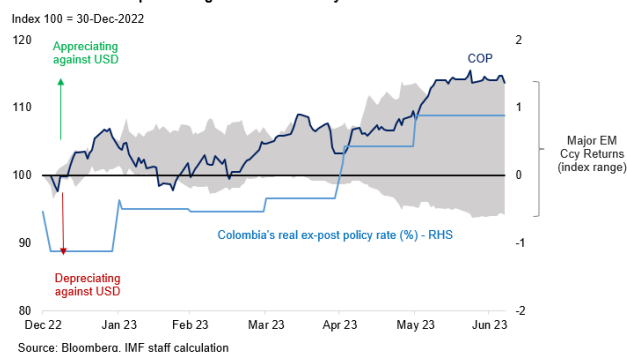


Sources: Bloomberg, and IMF staff calculations

Colombia

The Banrep meeting minutes do not see conditions “suitable” yet to start “relaxing” the restrictive monetary policy stance. Following its decision on June 30 to maintain policy rates at 13.25%, Banrep noted that it was necessary to remain a restrictive monetary policy given that inflation remains elevated, noting concerns over the “rigidity” of core inflation, the comparatively slower pace of disinflation relative to peers as well as other risk factors. The 3-month forward rates rose by +8bps to 13.15%, signaling that a rate cut remains unlikely over the next quarter. Alongside the Mexican peso, also the Colombian peso has been a major beneficiary of positive real policy rates and a large nominal rate differential versus Fed Funds, lifting the peso to outperform EM peer currencies so far this year.

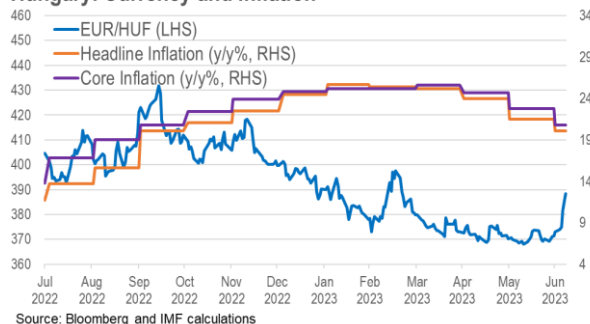
Colombia Peso outperforming its EM Peers this year



Hungary

Although inflation continued to ease, a weaker forint could undermine the anticipation of rate cuts. In line with expectations, data released this morning saw headline inflation declining for the fifth consecutive month in June to 20.1%/y/y (expected 20.1% from 21.5%), while core inflation eased to 20.8%/y/y (from 22.7%). While the central bank brought its policy rate to 16% with two consecutive 100 bps cuts in each of the past two meetings, market pricing is anticipating significant further rate cuts. As noted in yesterday's GMM, Goldman Sachs analysts highlight that market pricing anticipates about 175 bps of further easing per quarter over the next 12 months. However, other analysts caution that a weaker forint, together with still-elevated services inflation and a worsening current account deficit might require the central bank to ease less than market pricing predicts. The Hungarian forint weakened by -0.5% to 387.28/€ this morning, -5% weaker since the start of last week.

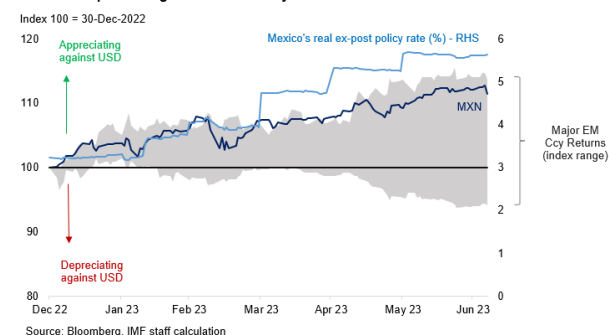
Hungary: Currency and inflation



Mexico

Banxico's June policy meeting minutes reveal apprehension for rate cuts. Although the central bank maintained its policy rate at 11.25%, board members warranted caution for rate cuts given the uncertain inflation outlook. The meeting minutes revealed that some members opined that “it is still too early to consider the possibility of interest rate cuts”, and that rates should remain at their “current level for a period that is long enough to ensure inflation declines in a sustained manner”. Interest rate swaps repriced year-end policy rate expectations marginally higher by +5bps to 10.94% while the MXN 6-month bank deposit rates rose +2bps to 11.47%, indicating that markets continue the magnitude of rate cuts this year, if anything, to be shallow. Recently, Mexico's comparatively high and positive real rates propelled the peso, which so far this year outperformed peer EM currencies.

MXN Peso outperforming its EM Peers this year



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Global Financial Indicators

7/7/23 8:58 AM	Level		Change				YTD
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	
Equities			%				%
United States		4413	-0.8	0	3	13	15
Europe		4243	0.5	-4	-1	22	12
Japan		32388	-1.2	-2	0	22	24
China		3826	-0.4	0	0	-14	-1
Asia Ex Japan		65	-1.9	-2	-2	-5	1
Emerging Markets		39	-2.0	-1	-1	-3	3
Interest Rates			basis points				
US 10y Yield		4.06	3.5	23	27	107	19
Germany 10y Yield		2.65	2.7	26	20	134	8
Japan 10y Yield		0.43	1.4	3	0	18	1
UK 10y Yield		4.69	3.3	31	44	257	102
Credit Spreads			basis points				
US Investment Grade		147	-1.5	-1	-16	-28	-11
US High Yield		439	-1.5	6	-30	-129	-42
Exchange Rates			%				
USD/Majors		102.88	-0.3	0	-1	-4	-1
EUR/USD		1.09	0.3	0	2	7	2
USD/JPY		143.2	-0.6	-1	2	5	9
EM/USD		48.5	0.1	-1	-2	-3	-3
Commodities			%				
Brent Crude Oil (\$/barrel)		76.7	0.2	2	0	-11	-8
Industrials Metals (index)		141	-0.1	0	-2	-7	-15
Agriculture (index)		67	-0.4	2	2	2	-3
Implied Volatility			%				
VIX Index (% change in pp)		15.5	0.0	1.9	1.5	-10.6	-6.2
US 10y Swaption Volatility							
Global FX Volatility		8.2	0.0	-0.2	-0.1	-3.0	-2.5
EA Sovereign Spreads			10-Year spread vs. Germany (bps)				
Greece		134	-1.7	6	1	-88	-71
Italy		173	-1.9	5	-9	-26	-41
Portugal		73	-2.3	-1	2	-37	-29
Spain		105	-2.4	6	3	-4	-4

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

Emerging Market Financial Indicators

Last updated: 7/7/2023 8:58 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	1 Day	7 Days	30 Days	12 M	YTD
	vs. USD		(+)= EM appreciation					% p.a.						
China		7.23	0.2	0.3	-1	-7	-5		2.7	-0.3	-3	-7	-28	-35
Indonesia		15135	-0.6	-0.9	-2	-1	3		6.2	4.0	-2	-9	-102	-70
India		83	-0.3	-0.8	0	-4	0		7.6	6.0	12	20	12.6	10
Philippines		56	-0.2	-0.8	1	1	0		5.9	1.3	1	1	28	-8
Thailand		35	-0.4	0.7	-1	3	-2		2.7	0.0	-3	14	6	12
Malaysia		4.67	-0.1	0.0	-1	-5	-6		3.9	2.5	6	22	-24	-13
Argentina		260	0.0	-1.4	-6	-51	-32		92.0	66.9	-1243	-1874	2396	381
Brazil		4.89	0.5	-2.2	1	9	8		10.9	-11.0	7	-46	-215	-170
Chile		804	-0.1	-0.2	-2	18	6		5.1	-12.0	2	-8	-143	-27
Colombia		4188	-1.2	-0.5	1	4	16		7.7	0.0	25	-73	-148	-213
Mexico		17.22	0.1	-0.6	1	19	13		8.2	0.0	15	-18	-56	-49
Peru		3.6	-0.4	-0.4	1	7	4		6.8	2.0	-8	-49	-102	-115
Uruguay		38	-0.3	-2.1	2	5	4		9.6	-3.3	-6	-45	-131	-112
Hungary		354	0.1	-3.5	-3	12	5		7.2	27.0	24	-51	-110	-236
Poland		4.10	0.4	-1.0	2	15	7		5.2	1.3	21	-8	-112	-93
Romania		4.5	0.2	0.1	2	7	2		6.6	1.8	-4	-16	-219	-108
Russia		91.6	-0.6	-2.5	-11	-30	-19							
South Africa		19.0	0.4	-1.0	0	-12	-11		9.8	7.1	24	-17	80	68
Turkey		26.06	0.1	-0.2	-11	-34	-28		16.9	0.0	0	202	-242	704
US (DXY; 5y UST)		103	-0.3	-0.4	-1	-4	-1		4.37	2.0	21	43	133	36

	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		Last 12m	Latest	7 Days	30 Days	12 M	
								basis points					
China		3826	-0.4	0	0	-14	-1		178	-8	-11	-28	1
Indonesia		6716	-0.6	1	0	0	-2		123	-9	-26	-99	-17
India		65280	-0.8	1	4	20	7		127	-2	-15	-76	-15
Philippines		6379	-1.5	-1	-2	0	-3		97	-8	-22	-73	0
Thailand		1491	0.0	-1	-4	-4	-11		0	0	0	0	0
Malaysia		1378	-0.6	0	0	-3	-8		89	-3	-7	-47	-11
Argentina		417549	-4.4	0	10	308	107		2068	-10	-336	-618	-137
Brazil		117426	-1.8	-1	2	17	7		243	-8	-18	-121	-31
Chile		5792	-0.7	0	2	14	10		121	-6	-14	-54	-11
Colombia		1115	-0.6	-1	-7	-17	-13		369	-7	-4	-65	-3
Mexico		53408	-1.2	0	-2	13	10		367	-9	-31	-79	-14
Peru		22276	-0.5	1	1	19	4		153	-11	-25	-44	-27
Hungary		49899	0.6	-1	2	26	14		205	-4	-29	-27	-17
Poland		66757	0.5	-1	1	24	16		129	-4	-12	55	56
Romania		12711	0.4	2	4	3	9		222	-3	-24	-116	-34
South Africa		74668	0.7	-2	-3	10	2		411	-4	-26	-108	44
Turkey		6182	0.7	7	11	155	12		490	10	6	-240	50
Ukraine		507	0.0	0	0	-2	-2		4243	85	-771	-1052	164
EM total		39	0.3	-1	-1	-3	3		387	5	-15	-75	12

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

[back to top](#)