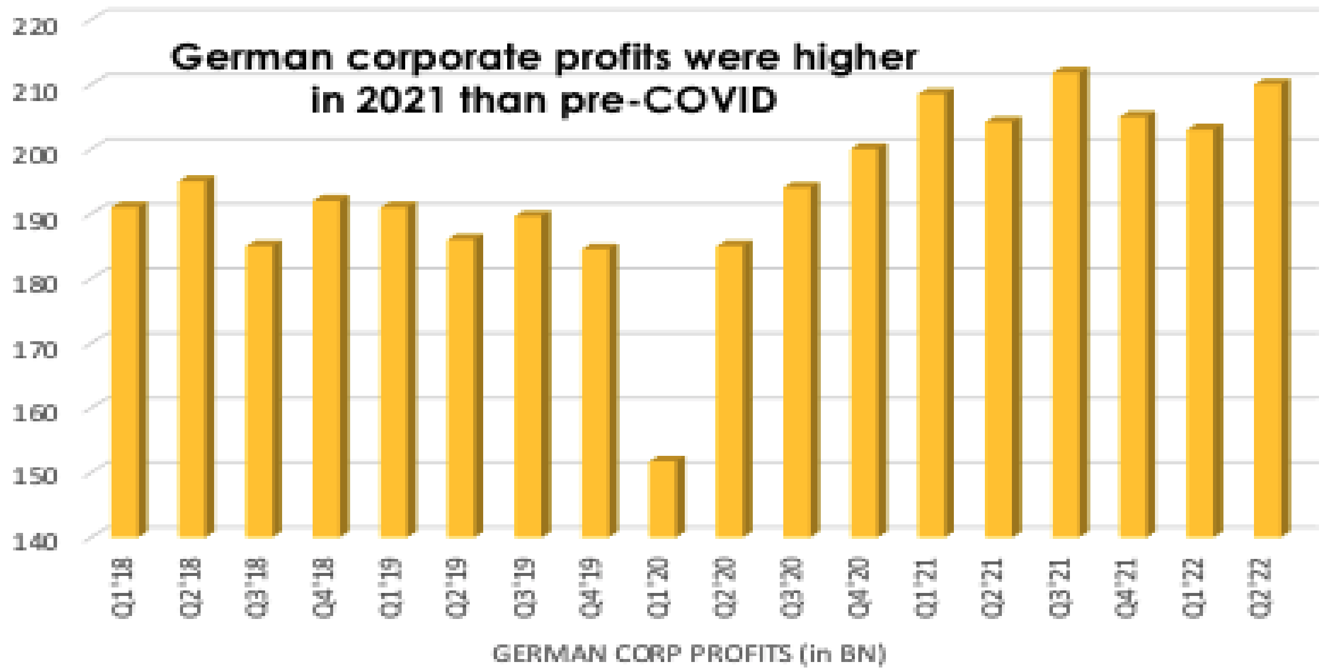
MACRO THOUGHTS

RESEARCH / MARKET COMMENTARY / CONSULTANCY

What good is production without consumers? Part two: ROW

Luck tends to be on the side of the EU; Europe is currently experiencing a mild winter, which has helped in maintaining energy stockpiles. It is to be hoped that this will encourage Russia to come to the negotiating table, since despite 'General Winter' seeming to have turned coat, and sanctions truly biting now in Russia, European politicians will be conscious of the cost to their economies and keen to move to the reconstruction phase of assistance, rather than have no end to the conflict in sight, which Ukraine will be acutely aware of – indeed, President Zelensky was keen to stress to President Biden that support for Ukraine is an 'investment in democracy', as he must worry that support may wane as the war extends.

Macron has often presented himself as a mediating diplomat, whilst Scholz has also come under some criticism and had to manage disengagement from many of Germany's past commercial links with Russia, whilst attempting to maintain stability in German industry, already suffering from the pandemic and waning Chinese support. When Russia started their 'special military operation' it was the impact on energy and agriculture that made the headlines, but the disruptions have been more widespread and run deeper, as Europe tried to recover from the COVID pandemic; Ukraine is a key supplier of car components for German manufacturers, for example.



With European gas stocks being filled early, helped by US imports via the UK, and with milder than usual weather, European gas prices have been falling, and like a number of commodities, are now lower than at the time of the February invasion, trading at roughly Eur74 a megawatt hour, while UK prices have already fallen by 3.5% to around 180p a therm. With oil prices now at the lowest in a year, households should be feeling slightly better off, though will remain cautious.

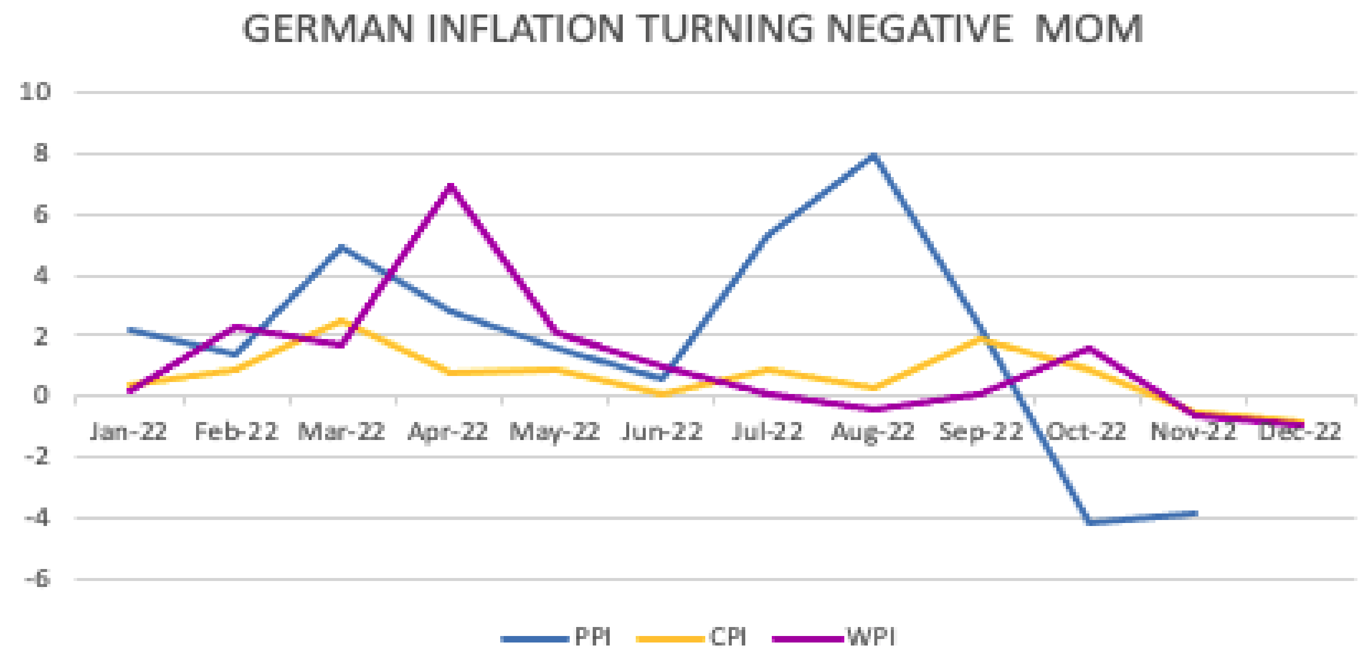
Since October, we have been anticipating a sharp correction down in inflation, with global CPI data releases considerably below consensus forecasts, and this should take some steam out of central bank expectations for tightening.

In 'What good is production without consumers? Part one: USA', we said: '*We believe some GDP forecasters will have to revise higher their growth expectations and lower their CPI expectations, because of the fall in energy and commodity prices….We had predicted, including on CNBC, that US CPI would surprise by slowing at a faster rate than consensus, and that the December meeting of the Fed could be the last for rate hikes, particularly as the tone of FOMC voters will be slightly less hawkish.'*

The Fed has so far ignored the warnings from retailers - if they were listening, they would already have ended rate hikes and be telling markets; Amazon have announced a further 18,000 jobs cut, on top of their previously announced cuts.

ECB PROJECTIONS DECEMBER 2022	2022	2023	2024	2025
CPI	8.40%	6.30%	3.40%	2.30%
CPI EX FOOD & ENERGY	3.90%	4.20%	2.80%	2.40%
GDP	3.40%	0.50%	1.90%	1.80%

Central banks may be focused on the annual change in CPI, but it will be the monthly trend that will impact on households. Our forecast for negative CPI month on month data, globally, has been reflected in German data for December, which was -0.8% mom (-0.3% expected) and EU Harmonised -1.2% (exp. -0.5%), the largest decline since January 2015. Annual CPI did drop from 11.3% to 9.6%, still high, but the base effects from 2020 and 2021 will still be impacting on 2022, and therefore data in 2023. Bavaria had one of the largest drops, falling -1.1% mom.



Lagarde and the ECB therefore could be risking a policy mistake and, instead of a mild recession, they could be underestimating the weakness in the European economy, if they are too aggressive. Europe's consumers have already suffered a lot over the past two years, and mistakes may not be tolerated by voters.

Italy has swung to a further right wing government under new PM Giorgia Meloni, and German Chancellor Olaf Scholz has been under pressure since assuming his position from Merkel. General and Parliamentary elections in 2023 include Estonia, Finland, Greece, Spain, Poland and Portugal, as well as state elections in Germany.

We anticipate that the rise in global bond yields in late 2022 has the potential to reverse, and maintain our US 10 year yield forecast for 3%, while recently raised expectations for more hawkish ECB and BOJ policies are already being questioned, especially as the BOJ is actively buying.

'Over the past two months, we have been recommending being short of Option Volatility and, despite the price action following the ECB, Vol. itself collapsed, RX Bund futures Vol. trading below 10%, where some profits might be taken', **Macro Thoughts, December 1, 2022. The ECB set the course of 50bp hikes with intermittent reviews of policy over the first half of 2023. At the same time, the ECB will be reducing their balance sheet by Eur15bn from early March, roughly half the redemptions over that period.**

December's meeting does put the ECB on the front foot and at least a 50bp hike can be expected at their February 2 meeting, which will follow the Fed's first meeting of the year. The next meeting will be on March 16 and, by then, EU CPI should be considerably lower, and the focus on Q1 growth a greater concern.

Our ultimate forecast for rate increases is therefore lower than consensus, which is targeting 150bp of

increases by mid-year, to between 3.50% and 3.75%. Disappointment could see rate increases to just 3%, and certainly, if the trajectory of slowing inflation continues, then there is little reason to expect rates at 4%, making the risk/reward of lower expectations compelling.

The ECB will still need to be vigilant on peripheral bond yields, but so far, even last December's volatility had a limited impact on spreads, and the German/Italy 10year bond spread held 250bp (2022 high was 260bp), while the spread between Spain and Italy should fall back below 100bp.

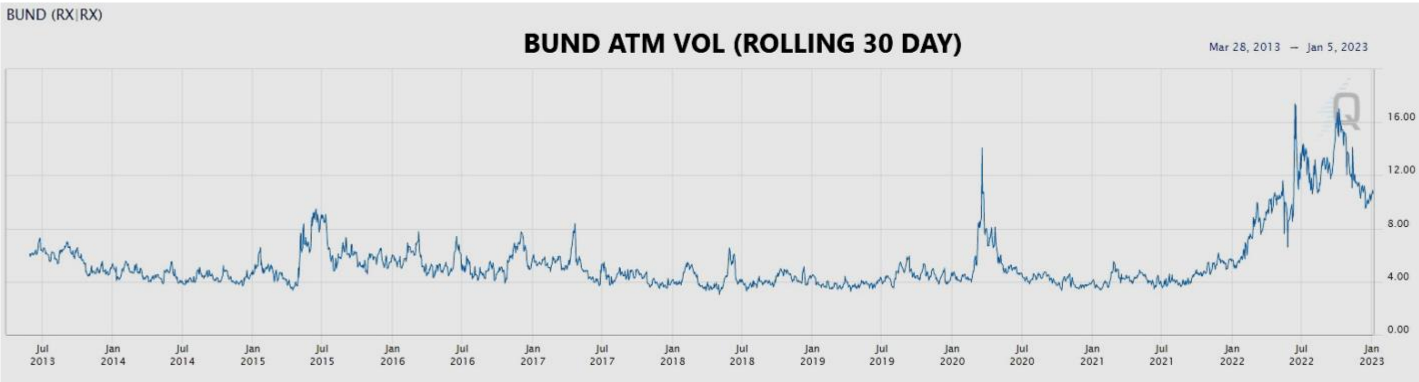
EURUSD has started 2023 as it ended 2022, moving towards 1.06 (we target between 1.10 and 1.12), as the Fed comes towards the end of its rate hiking cycle and the ECB continues raising, after the Fed. China has signed an agreement to buy oil from Saudi Arabia in Yuan (covered later in this report), reducing the demand for Petrodollars. Both the ECB and the Fed should raise by 50bp at their next meetings, so it will be the tone of each governor that will be in focus, potentially giving a further boost to momentum for the Euro, particularly as sentiment data show that retail traders are currently short.

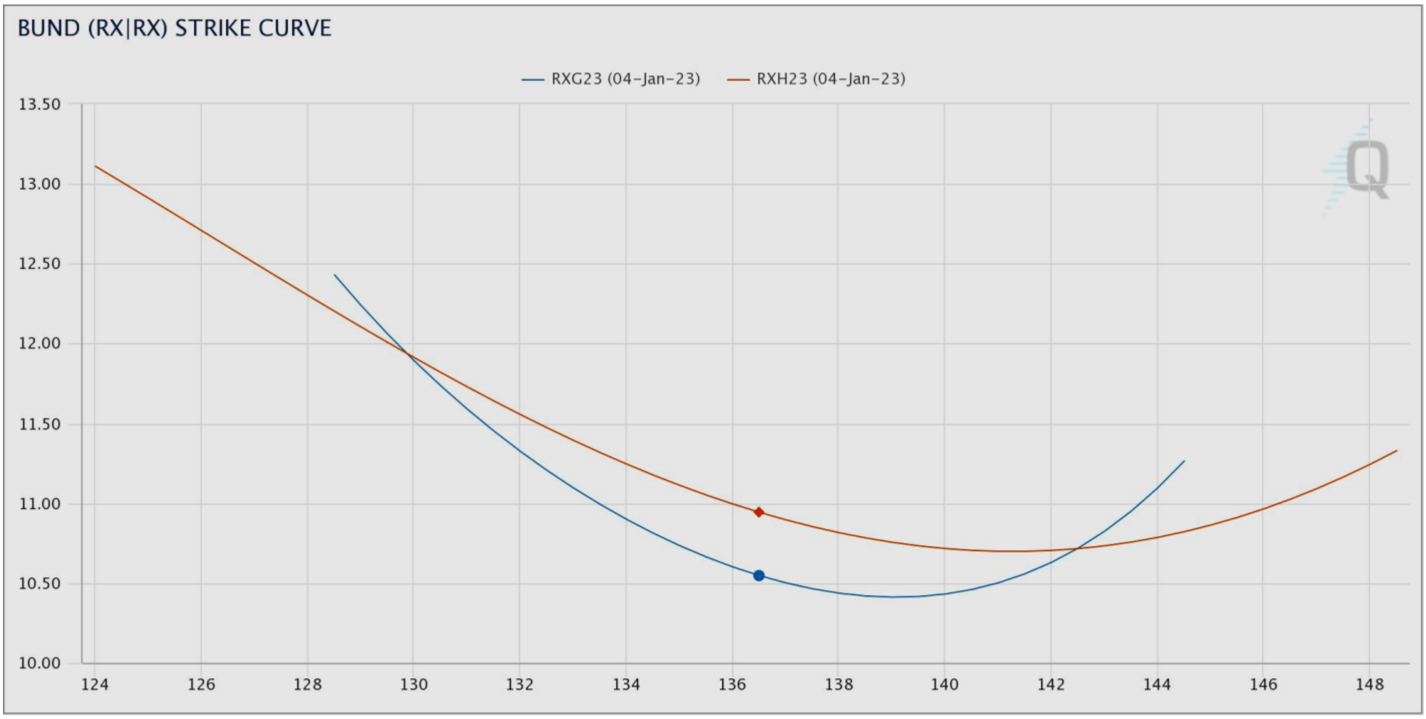
Eurostoxx 600 YTD for the first four days of the year has risen 2.6% (from 425) and after the volatility of 2022, some might be hoping this year closes at that level, and certainly 400 needs to hold, while few will forecast exceeding 500. *During 2022, S&P performance fell -20%, Euro Stoxx -13% and FTSE was flat;* FTSE has been trying to break above 8,000 for years.

We said on December 9, 2022: *'Accumulative/Composite Put/Call skews across asset classes in US markets are approaching the extreme levels seen during the Fed tightening cycle of four years ago, warning of an imminent reversal of policies. We have said the higher ranges for Volatility in equities and bonds during 2022 are likely to break lower next year and, since our forecast, Vol has dropped. Although there is likely to be price Volatility in the underlying instruments, implied option volatility can be expected to trend within the teens for VIX and around 6% for Bunds and TY$ in 2023.'*

US TY$ 10 year Volatility is now below 8%, dropping below the top of the range and towards 6%, which we targeted for 2023, compared with circa 11% towards the end of the year.

Going into the final ECB meeting of the year, we had advised hedging positioning with strategies that produced short positions in RX Bund Futures Option Volatility. Despite the underlying price movement, Bund Volatility has continued to fall since the time of the ECB meeting and this should persist; having been above 16% at the beginning of October, Vol is now trading below 11%.





Economists are targeting the UK to experience the worst of the downturn, however, with the right policies, there is a strong possibility it can outperform most of Europe. Energy prices will be an issue on both sides of the Channel, but the spending power of the Dollar will still make the UK attractive, especially after the televised pageantry of the Queen's funeral and the upcoming coronation.

According to the Office for Budget Responsibility's forecasts, UK CPI in Q4 2023 will fall to 3.8%, nearly two thirds lower than Q4 2022, and that may need to be revised closer to 3% over the next few months.

In December, as Gilt 10 year yields fell to 3%, we said: *'UK 10 year Gilts have fallen well over 1% since the spike to 4.50%, and are close to falling below 3%, though may not have the same juice to fall much lower, which should continue* *to support Sterling (in my CNBC interview, I suggested GBPUSD moving back to 1.25; Cable has since moved up by 3 big figures)',* Macro Thoughts, December 1, 2022.

Even more acutely than in the US, 50% of UK landlords had been forced to reduce rents by up to 10% in Q4, because of the unaffordable rise in the cost of living. Perhaps reflecting the new hybrid working from home culture, in the wider London market, average rental prices fell from £568 per week to £551 between October and November, according to Foxtons estate agents.

By the middle of the year, as global rate increases start to be priced for reversing, with a better year for finance and Sunak forced into less constrictive policies, a resilient UK consumer is likely to surprise many forecasters. UK GDP is expected to shrink by -1% in 2023, compared with a contraction of just -0.1 % for the Eurozone, which we see as being too optimistic for Europe and too pessimistic for the UK.

Q3 GDP gross fixed capital formation (GFCF) increased by 1.1%, partly driven by a boost in government investment of 17.3%, and although business investment fell by 2.5%, there were notable revisions to estimates across quarters because of updated survey data; as with most economies, the UK's remains (8.1%) below its pre-pandemic level.

Throughout 2022, despite weakness in GDP, business investment surprised to the upside during the first half of 2022, and it has been largely overlooked that UK retail sales are by volume and not value, therefore should stand out as Europe's consumer activity remains subdued.

While reopening the Rough Gas Storage facility, the UK also set a new record for wind generation power from onshore and offshore turbines in 2022, according to the National Grid's electricity system operator (ESO), which recorded wind generation, on December 30, of 20.91GW (gigawatts), which was the third record in 2022. A new record was also set for the share of electricity on the grid coming from zero-carbon sources, which supplied 87.2% of total power.

The fall in global wholesale prices should increasingly be reflected in retail and, therefore, by the second half of the year, construction and the property markets should stage a recovery, further encouraging foreign investment. Infrastructure and other projects, such as the expansion of media and film studios, will also support GDP. There are tentative signs of greater co-operation between the UK and the EU, while Spain is setting tax incentives to encourage UK tech expertise to help build the potential of Spain.

'The price cap is dragging oil below the pivotal $80, and prices have now dropped to the lowest in 2022, which should bring CPI down even quicker, while at the same time support confidence in consumers and manufacturers', Macro Thoughts, December 9.

BASF's largest plant uses as much gas as Switzerland and has become reliant on doing business in China, worth Eur12bn of its annual revenues, and is currently building a Eur10bn chemical complex in Guangdong, the largest foreign investment in its history, ignoring Xi's politically-led economic policies.

Having set a price cap for Russian oil at $60 and the rest of the world falling in line, Russian Ural oil prices have fallen from $70 at the beginning of December and are now close to breaking below $50, falling 10% since the beginning of 2023. Russia is sending more crude oil produced in the Arctic region of Arco/Novy Port and Varandey to China and India, and at even steeper discounts. Arctic crude exports to India have been increasing since May, reaching a record 6.67 million barrels in November and 4.1 million in December.

In our March 17, 2022 report, we highlighted the relationship between Russia and Belarus in contrast to the vulnerability of others in the region, who ultimately will either need to develop closer ties with Europe, or risk Russia's greater influence: 'three small Baltic States, members of NATO, spent half of the 20th century under Soviet rule; Latvia, Lithuania and Estonia have increased defence spending to above 2½% of GDP, compared to NATO's requirement of 2%.'

Around 35% of the Latvian population identify themselves as ethnic Russian, the largest of the three states, and in Estonia it is around 30%. Although the focus has been on Germany's imports of Russian energy, Estonia and Lithuania import up to 75% of their oil and natural gas from Russia, and Latvia 25%, while Gazprom used to own significant stakes in all three of the Baltic states' main gas companies, though this has declined since 2014, as the states tried to lower their energy dependence on Russia. That said, Estonia's negative trade balance grew in 2021, from Eur55.6mio to Eur168mio by January 2022, with Russia its second largest trade partner.

Therefore, although Putin's imperialistic, military ambitions may have instigated the original incursion into Ukraine, the economic impact has been felt also by countries such as these, trying to move away from Russian economic influence and towards Europe and the West.

We believe Croatia's adoption of the single currency should pass without any major disruption, however rapid expansion, and the economic standing of those potentially joining, will add vulnerability to the bloc, with greater risks in markets and therefore higher volatility, which the EU can ill afford.

Poland has been the greater recipient of EU grants and, along with Hungary, has been the least cooperative with the EU's Rule of Law mandate, however, their influence over original members, such as Austria and parts of Germany, has been growing.

The conflict in Ukraine has led to cheap energy being exported from Russia to China, which won't improve Chinese relations with the US, and the recent 'Top Gun' episode, involving a Chinese fighter plane flying within feet of a US military surveillance plane over the South China Sea, could have turned into an international incident. North Korea has just recently fired three ballistic missiles towards the Sea of Japan.

Demand for energy has also elevated Iran's importance, as China and India have both increased their oil imports and potential deals involving oil may also be helping Russia amid the sanctions. However, the US has been exporting gas to Europe through UK terminals, Russian oil is being sold close to $50, and a 1/3rd of the global economy is expected fall into recession (not helped by the tightening of financial conditions), so energy prices should continue to be subdued during the first half of the year.

Having signed an energy agreement with Saudi Arabia to be paid in Yuan, China has made a large step towards making the Yuan a dominant Reserve currency. To support this, China has bought around 300 tonnes of gold during the latter part of the 2022, in part offsetting market liquidation in the ETF market. To compare, central bank gold demand is said to have been 364 tonnes by October (including recent purchases by China and others adds nearly 300 tonnes). Saudi's exports to China were worth $33.4bn, therefore the net trade surplus was roughly $1.6bn.

In January 2020, we were aware of a deadly SARs-type outbreak in Wuhan; we warned markets, and even wrote to UK Cabinet ministers, and by March global stock markets collapsed, yet throughout that year, Chinese authorities played down the true impact of the pandemic. Today, after months of lockdowns and cases said to be in the tens of millions, China is again pushing the responsibility out, lockdowns are being lifted after violent demonstrations and, globally, travel restrictions are again being introduced on passengers leaving China.

We said in our 'Week Ahead' December 18: *'As China begins to bow to pressure to relax lockdowns, economists and those trading with China may have become too excited. State media has a caution from one of China's top health experts, who has warned of a surge in COVID cases – governments around the world should have learnt from their* *mistakes in 2020, however the spread in China now is far worse than when we first highlighted Wuhan's first 'SARs-type' cases on January 5, 2020.'*

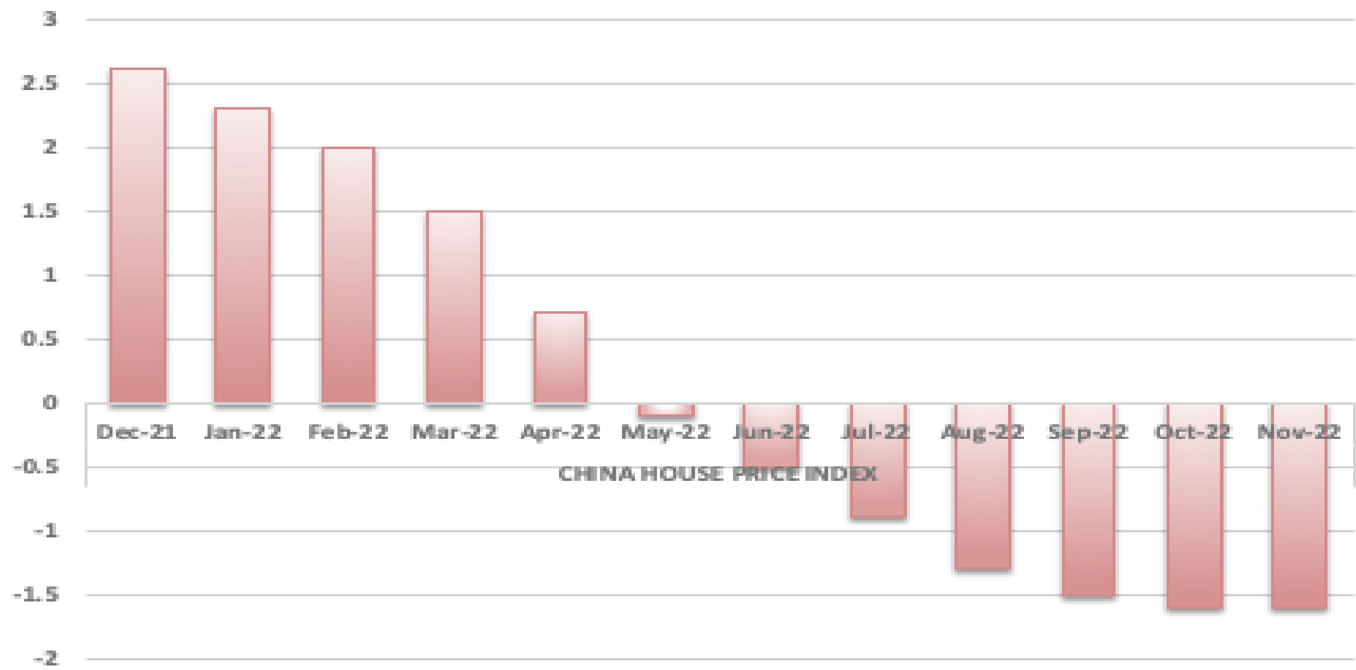
At this time of year, forecasts for the coming year are common, however, few are taking into account that, by Autumn, COVID restrictions are likely to be applied not just on China, and this will be on top of a war in Ukraine.

Fear is spreading in countries neighbouring China. Malaysia, Singapore and Thailand are major tourism destinations for Chinese travellers, with direct flights provided, and concerns are growing over the return of Chinese tourists for the Lunar New Year on January 22. Movements due to the Lunar new year in 2020 were the first super-spreading event, with the Chinese authorities taking the decision not to restrict movements until after the national holiday. Thailand is expecting around 10 million Chinese tourists, but the Thai health minister, Charnvirakul, has said the Thai public should not be worried about the expected influx of visitors.

Arguably, vaccinations will provide greater defence now, but as we know from the many variants, COVID can quickly mutate, so this is no time for complacency.

China's COVID problem is another of several issues which are making structural changes in dealing and trading with China inevitable, and already influencing decision-making in the boardroom meetings of every large corporate around the world.

Chinese iron ore prices have fallen back as the steel-making raw material started to correct, following the recent bullish period of higher prices as lockdowns start to relax. However, China's Non-Manufacturing PMI dropped to 41.6 in December, from 46.7, and Manufacturing PMI dropped a point, to 47, despite consensus forecasts for an improvement.



The Chinese property market has been intrinsic to its economy throughout its urbanisation revolution, which has made it too easy for developers to be given funding, and therefore companies such as Evergrande have largely gone unchecked, and been a favourite for foreign investors.

The collapse of Danke Apartment, one of China's largest online apartment rental platforms in 2020, illustrated how the fall in one Chinese company has consequences for the whole financial system. At the end of the previous year, more than 91% of Danke's tenants paid rent via rental loans, more than 90% of these issued by WeBank, accounting for 73.8% of Danke's total revenue in 2019. We said at the end of 2020: *'But pull the wool at one end of this ball of knots and the whole lot comes tumbling down, and it seems the authorities are no longer there to make the saving catch.'* This was later proven, by the fall of Evergrande and the lack of support given to foreign investors.

With the property market, which accounts for 30% of Chinese GDP, spiraling lower, and slowing demand for manufactured goods globally, foreign investment, which is highly important for the economy, has according to some been slowing since COVID, though we might argue that the deceleration in FDI had started long before 2020.

Now, as US and Chinese interest rates converge, and with the high volatility of the Yuan, it may be difficult to see a reversal soon, particularly as official figures showed record FDI in 2020 and 2021 were inflated by short-term investments, fueled by unique macroeconomic conditions. FDI increased 9.9% yoy, to CNY1.16tn in the first eleven months of 2022 in USD terms, rose 12.2%, led by high-tech industries, which increased by 31.1%. **Since Q2 2022, inflows have slowed sharply, from a record high of $102bn in Q1, to a 20-year low of $13bn in Q3, just six months later.**

Since our timely report for 'Outlook India' in October 2021, which discussed foreign investment in China and the potential for India, there has been a particular shift. Led by infrastructure and energy deals, India gained 13% FDI growth in 2020, one of the strongest performers in a difficult year, having been ranked in the low 60s of 190 countries for FDI.

Yuan trend moves are considerable - so much so that, since 2015, there have now been six trend opportunities, including the recent correction, of around 45 big figures. While this may be good for traders, for longer term project investors this creates problems, not least for invoicing.

As we have been highlighting since China increased their militarisation of the Spratly and Paracel islands in the South China Sea, in the past, China's main aim of annexing Taiwan may have been said to be based on older histories, but its aims now are more modern - to capture the semiconductor technology and the markets that Taiwan dominates.

AI is the next industrial revolution and data is the new oil; semiconductor technology and the ability to place microchips into every household is the driver. AI and data will dictate and drive future economic growth, jobs creation and opportunity, as well as dictating global politics in managing climate change and fixing the environment, water, energy and pollution.

The winner of that game takes all, and with the world being increasingly divided, military hardware, 5G and other technologies, will be essential. Yet these markets are in their infancy, and other technologies have yet to come into play, but while governments are pushing for combustion engine vehicles to be scrapped within decades, their replacements may not yet have been invented.

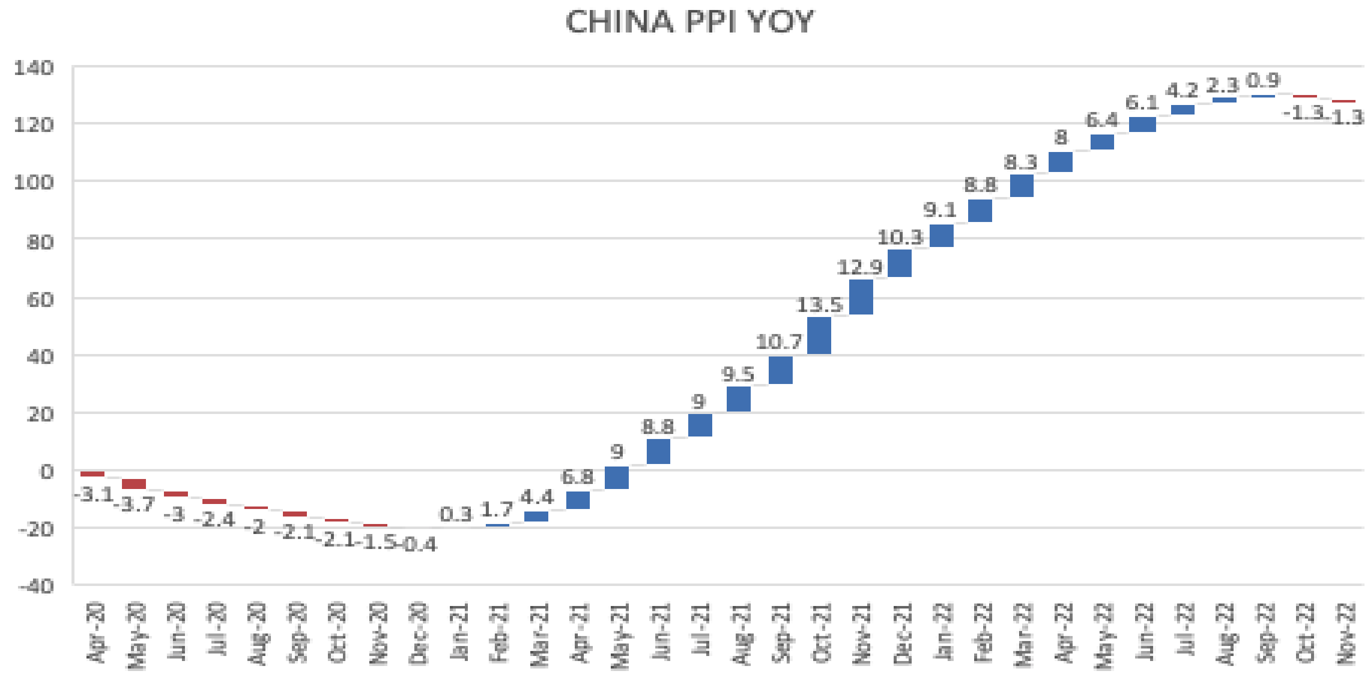
Huawei has just patented a method of making ultra-small microchips, a capability that had been closely guarded by the West, and at the end of last year, Chinese researchers issued a scientific paper claiming to have found a way to break encryption using quantum computers; whilst this is being assessed by the global scientific community, if this claim did prove to be correct, it would mean that governments could access the secrets of other governments, but it is currently assumed that the Chinese research still does not address how fast the algorithm will run, since they hadn't yet scaled up their findings.

Despite 25% of Hamburg's port set to be owned by China, Germany will need to disengage its dependence on China, especially as Xi's policies are aimed at growing Chinese companies for the Chinese people. In the short term, however, it will take time for China to pull itself up from its current nosedive, and if China slows, Europe slows. German exports to China in November showed no growth and imports from China were up just 0.8%, little better than the 1% fall from Russia.

In December, Germany's Economy Minister, Habeck, *recommended* excluding using components from providers from authoritarian states such as China in critical infrastructure and aimed to impose stricter requirements for firms dealing with China.

But, along with Honda, BMW and VW have plans for new factories and to expand production in China, in their long-term commitment to China's auto market, the largest in the world. In July, BMW officially opened its new factory in Shenyang, following an investment of around Eur2bn; the plant is the biggest single investment in BMW's history in China. So again, while governments may try to pull away from commitments to countries such as China and Russia, their companies are continuing, regardless, despite VW being forced to close several factories due to Chinese lockdowns.

Having been exiled, reinstated, purged and then making another come back, after a fractious battle for the leadership, by 1980, the diminutive Deng Xiaoping was in a position to guide the Chinese authorities, and begin the change that would see Chinese GDP grow from the same size as Malawi's, to one of the two largest economies in the world. From the foundations he laid, by the start of the 21st century, China was becoming one of the leading economies to drive growth and corporate profits, while at the same time keeping global inflation low.



Mao had moved Chinese middle classes to work on farms and the economy had collapsed; Deng, having seen the progress and potential from examples in Japan, knew there had to be change. Famously, he was in wonder at Japan's high speed railways – today, China has a greater length of high speed train tracks than the rest of the world, combined.

It is easy, therefore, to understand why productivity has remained so low, while inflation and wage growth have been kept under control in the West for the past two decades, when China's urbanisation has meant a worker moving from farming to factory employment increased their productivity by 20%. And why corporates have been drawn to the potential of the Chinese consumer.

In the summer of 1977, Deng called a conference in Beijing on the future of education. This would be the first small step to changing the world. A proposal was made by Professor Wen Yuankai that exams should start again as soon as possible and that they should be free, fair and open to all; 5.7 million applied for university entrance exams. In 2021, under President Xi Jinping, private tutoring has been banned, a major blow to the aspirations of Chinese parents, and a 180 degree change that enforced the ideals of China under the new authorities.

*Bund Options Volatility charts thanks to Neil Leonard, RJ O'Brien

	Selection of strategies to leverage reports in 2022
January / EOY Carry Over	Sell UK 10 yr 0.50%
	Sell RX GER 10 year 170
	Sell TY$ 129.50
	Sell GRK/Buy ITL 5bp or Buy ESP
	Sell China 10 yr 133bp
	US Curve Flatteners ref 5yr-10yr 50bp target into negative
	Sell S&P 4662
February	ED US STIR Futures spread Sell EDZ3 Buy EDZ4 @3tic
	ED US STIR Futures B'fly Sell EDM3 Buy EDM4 Sell EDM5 @3tic
March	Sell S&P 4800
April	Buy USDCNH 6.42
	Buy USDTHB 33.50
	Sell EURUSD 1.08
May	Sell Commodities (Lumber, Copper, Soybean etc.)
	Buy Option Vol RX Bunds & TY$
	Buy USDINR 77.32
June	Buy US 10 year /Sell 10yr 3.40%
	Sell Oil WTI $120
August	Buy VX 20%
September	Sell UK 10yr 3.06%
	Sell ITL 3.88%
	Sell EM Currencies
	Sell EURUSD
	Spread widener ITL-GER 2.27
October	Buy US 10 yr 4.30%
	Buy Investment Grade Bonds
	Sell Fixed Income Option Volatility
	Sell USDJPY
	Sell GBPJPY
November	Buy GBPUSD
December	Sell UK 10 yr
	Buy ED June 23 Futures (re CNBC)
	Fade Extreme TY$ Put/Call Skew

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