Market comment_05Aug2023

BOJ tweaked YCC policy, triggering the "butterfly effect" and impacting "global asset pricing."

Sandy Wang, 5 August 2023-6 pm SGT

Key Takeaways:

- *The US dollar index rebounded to around 102, showing the appreciation was restrained;*
- *The US dollar maintains its strong rebound throughout the week but encounters resistance after the release of non-farm payroll data on Friday;*
- *The continued decline in US job openings for June further supports the notion of a cooling US labor market;*
- *Fitch Ratings downgraded its US debt rating to dampen the momentum for further appreciation of the US dollar;*
- *US Treasury ramps up debt issuance, and US 10Y Treasury yield rises above 4%;*
- *US yield curve inversion narrows, and US stock indices may enter a period of decline;*
- *If the US Dollar remains strong, USDJPY could target 145;*
- *BOJ tweaked YCC policy, triggering the "butterfly effect" and impacting the US 10-Year Treasury Yield;*
- *Minutes of the Bank of Japan's monetary policy meeting in July indicate greater flexibility in conducting the Yield Curve Control (YCC);*
- *The Reserve Bank of Australia holds rates steady, and the Australian dollar weakened; The Reserve Bank of Australia (RBA) maintains the benchmark rate at 4.10% for the third consecutive month;*
- *China's announcement of terminating the anti-dumping and anti-subsidy tariffs on imported barley has provided limited support for the Australian Dollar's momentum.*

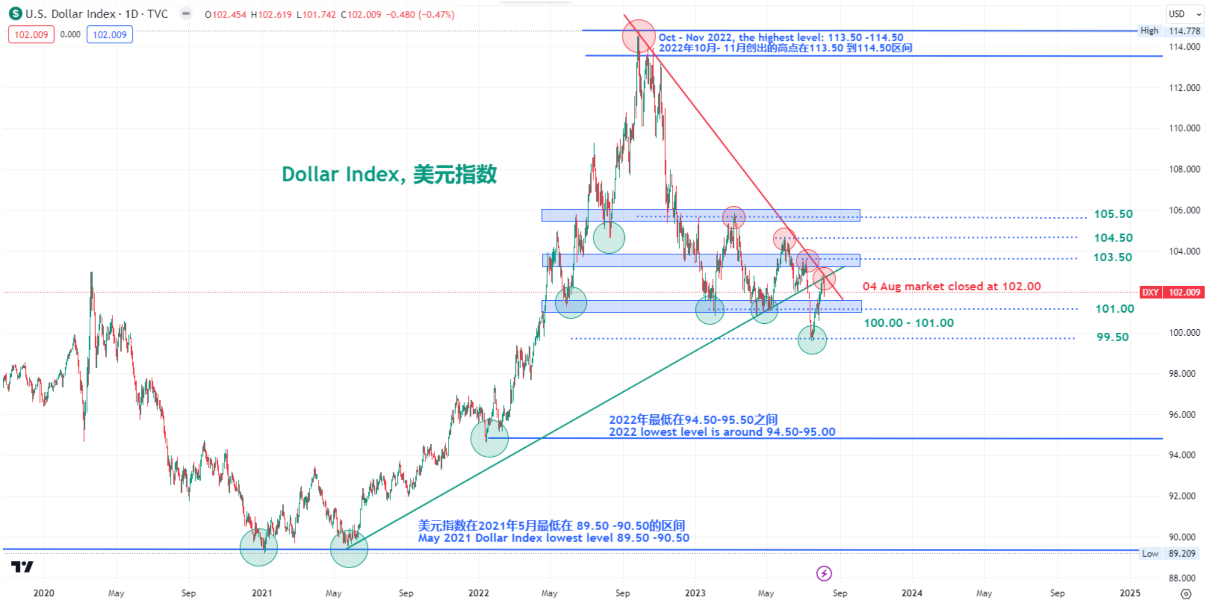
1. The US dollar index rebounded to around 102, showing the appreciation was restrained.

1) The US dollar maintains its strong rebound throughout the week but encounters resistance after the release of non-farm payroll data on Friday.

A series of economic data released earlier this week, favorable for the US economy, has stimulated the Dollar Index, driving its continued strong uptrend. In the first week of August, the Dollar Index surged to a peak of 102.80. On Tuesday (2 August), the US ADP Employment Report for July showed an increase of 324,000 jobs, surpassing the expected 189,000 and significantly lower than the previous month's (June) 455,000. On Thursday (3 August), the US ISM Non-Manufacturing PMI, ISM Non-Manufacturing New Orders Index, ISM Non-Manufacturing Prices Paid Index, and ISM Non-Manufacturing Employment Index for July were reported at 52.0, 52.7, 55.0, 56.8, and 50.7, respectively, all remaining above the 50-point threshold. The service sector constitutes over 80% of the US GDP, making the stability of service-related economic data above 50 one of the reasons for the potential soft landing of the US economy. On Thursday (3 August), the US Bureau of Labor Statistics announced a significant growth of 3.7% in US non-farm productivity for the second quarter of this year, surpassing the expected 2.0% and the previous quarter's -1.2%. Non-farm productivity measures the output per hour worked by each employee and is a crucial indicator of the health of the US economy, with a direct impact on the US GDP.

After the release of the mixed US July Non-Farm Payrolls and Average Hourly Earnings data on 4 August, the Dollar Index experienced a drop of nearly 100 points to around 101.75 in the short term, ultimately closing at about 102.01. The US Bureau of Labor Statistics reported that the seasonally adjusted non-farm payrolls for July recorded an increase of 187,000, the smallest gain since December 2020 and below the market expectation of 200,000. The previous month's data for June was also revised downward from 209,000 to 185,000. Additionally, the US unemployment rate for July was reported at 3.5%, lower than both the expected and previous value of 3.6%, remaining at a near 50-year low. The average hourly earnings for July (YoY) were recorded at 4.4%, slightly higher than the expected 4.2% and unchanged from the previous value of 4.4%. The average hourly earnings for July (MoM) were reported at 0.4%, slightly higher than the expected 0.3% and unchanged from the previous value of 0.4%. The ongoing downward revisions in non-farm payroll data indicate a cooling of labor demand in the US, but the continued strong growth in wage levels is evident. July's average hourly earnings growth remains steady at 4.4%, similar to June's figure. While this is lower than the same period last year (July 2022) at 5.2%, it still surpasses the levels before the outbreak of the COVID-19 pandemic (3.2% in July 2019).

- *On Friday, Nick Timiraos, a Wall Street Journal journalist known as the "Fed Whisperer" and the "New Fed Communications Agency," wrote that "employers slowed their hiring this summer, adding to signs the economy is gradually cooling, and easing pressure for the Federal Reserve to raise rates at its next meeting." He added that recent wage gains are inconsistent with the low and steady inflation that economists have come to expect. Assuming modest worker productivity growth, annual wage growth should be around 3.5% to bring inflation more in line with the Fed's target.*
- *Federal Reserve Chair Jerome Powell stated in a July meeting that we have to be honest about history, and history tells us that central bank interventions to slow down the economy to reduce inflation often result in softening labor market conditions.*
- *President of the Federal Reserve Bank of Atlanta Raphael Bostic noted that US job growth is orderly slowing, and further rate hikes aren't necessary to fight inflation. However, Bostic's fundamental outlook is that there won't be any rate cuts before the latter half of 2024.*
- *President of the Federal Reserve Bank of Chicago Charles Evans mentioned that the job market is cooling, denied wages being a leading indicator of inflation, and suggested it's time to consider how long to maintain rates.*



Source: TradingView

The Dollar Index (DXY) has remained in a range between 100.500 and 105.50 from December of last year to the end of July this year, fluctuating for over six months. Following the significant drop in US June CPI data to 3% announced recently on 12 July, the Dollar Index experienced a sharp decline, falling below the critical psychological level of 100.00 and reaching a low of around 99.50. Over the past three weeks, it has rebounded and risen continuously, reaching a peak of approximately 102.80 this week. As of the end of this Friday (4 August), it closed at around 102.00.

Since last week's dovish July rate meeting of the European Central Bank, coupled with a significant retreat of the Euro and bolstered by a series of favorable economic data releases at the beginning of this week, the Dollar Index maintained a strong rebounding trend for the first four days of the week, reaching a peak of around 102.80. Meanwhile, commodity currencies like the Canadian Dollar, Australian Dollar, and New Zealand Dollar experienced the most significant declines this week. Following the release of weaker-than-expected US non-farm payroll data for July on Friday, market expectations for further interest rate hikes by the Federal Reserve diminished. As a result, the Dollar Index experienced a sharp decline in the short term, reaching a low of around 101.75, nearly erasing all the gains made earlier in the week. The robust growth in average hourly earnings reported on the same Friday continued to support the market's anticipation that the Federal Reserve might have grounds to maintain higher interest rates. Consequently, as of the market close on Friday (4 August), the Dollar Index managed to hold above the 102 level resiliently.

The following summarizes the price movements over the past week:

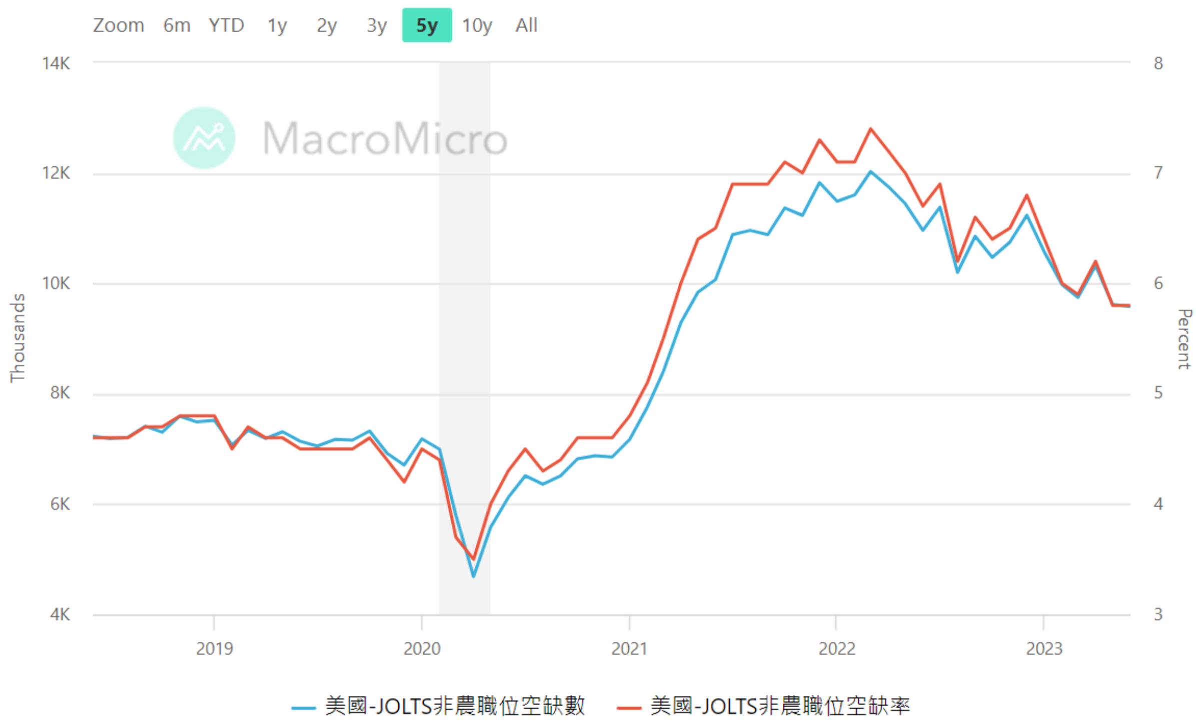
- *The DXY fluctuated within a range of 100 pips (101.70-102.80-101.75). After the release of the non-farm data on Friday, it dropped by 85 pips (102.60-101.75) and closed at 102.00 on 4 August. Compared to the closing price 101.70 on the previous Friday (28 July), it recorded a minor increase.*

- *The EURUSD fluctuated within a range of 150 pips (1.1050-1.0900-1.1040). After the release of the non-farm data on Friday, it increased by 100 pips (1.0940-1.1040) and closed at 1.1005 on 4 August.*
- *The GBPUSD fluctuated within a range of 230 pips (1.2850-1.2620-1.2790). After the release of the non-farm data on Friday, it increased by 110 pips (1.2680-1.2790) and closed at 1.2748 on 4 August.*
- *The AUDUSD fell by 220 pips (0.6740-0.6520). After the release of the non-farm data on Friday, it increased by 50 pips (0.6550-0.6600) and closed at 0.6563 on 4 August.*
- *The NZDUSD fell by 170 pips (0.6230-0.6060). After the release of the non-farm data on Friday, it increased by 60 pips (0.6070-0.6130) and closed at 0.6096 on 4 August.*
- *The USDJPY fluctuated within a range of 300 pips (140.80-143.80-141.70). After the release of the non-farm data on Friday, it dropped by 100 pips (142.70-141.70) and closed at 141.70 on 4 August.*
- *The USDCHF fluctuated within a range of 140 pips (0.8665-0.8805). After the release of the non-farm data on Friday, it dropped by 80 pips (0.8780-0.8700) and closed at 0.8727 on 4 August.*
- *The USDCAD increased by 230 pips (1.3150-1.3380). After the release of the non-farm data on Friday, it dropped by 60 pips (1.3380-1.3320) and closed at 1.3380 on 4 August.*
- *The USDCNH saw an upward fluctuation of 720 pips (7.1400-7.2120). After the release of the non-farm data on Friday, it dropped by 200 pips (7.1950-7.1750) and closed at 7.1858 on 4 August.*
- *The USDSGD increased by 170 pips (1.3280-1.3450). After the release of the non-farm data on Friday, it dropped by 70 pips (1.3435-1.3365) and closed at 1.3375 on 4 August.*
- *Gold fell by $42 per ounce (1972.00-1930.00). After the release of the non-farm data on Friday, it increased by $17 per ounce (1930-1947) and closed at $1942.50 on 4 August.*
- *Bitcoin fluctuated within a range of 28500-29850. It closed at 28867 on 4 August.*

2) The continued decline in US job openings for June further supports the notion of a cooling US labor market.

The US Job Openings data is one of the most closely monitored financial indicators by Treasury Secretary Yellen. Since falling below the 10 million mark in May of this year, the data for June once again registered a slight decrease, recording below 10 million. On Tuesday (1 August), the US Bureau of Labor Statistics reported that there were 9.582 million job openings in the US for June, which was lower than the expected 9.62 million and the previous month's (May) 9.616 million. This figure also marked a new low, the lowest in over two years (since April 2021).

The ratio of job openings to unemployed for June, which compares the number of job openings to the number of unemployed individuals, declined from 1.82 in April to 1.61. Before the outbreak of the pandemic, this ratio was around 1.2. In other words, on average, there were 1.6 job openings per unemployed person in the US. Since the Federal Reserve began raising interest rates in March of last year, marking an interest rate hike cycle lasting over 17 months to the present, the US non-farm job openings have fallen below the 10 million mark for two consecutive months. While this response came somewhat late, it has partially alleviated market concerns about the potential for long-term structural inflation in the US. It also suggests continuous cooling in the US labor market.



Source: MacroMicro

The words in the picture above:
Blue: US JOLT Job Openings
Red: US JOLT Quits Rate
Both the US JOLT Job Openings and the US Quits Rate are on a downward trend, signaling a potential cooling of the US labor market.

3) Fitch Ratings downgraded its US debt rating to dampen the momentum for further appreciation of the US dollar.

On Tuesday (1 August), Fitch Ratings, one of the world's three major credit rating agencies, downgraded the US debt rating from the highest AAA to AA+. Fitch's rationale for downgrading the US debt rating primarily revolves around two factors. The first one is the erosion of US governance. In Fitch's view, there has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters, notwithstanding the June bipartisan agreement to suspend the debt limit until January 2025. The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. The second reason is the rising general government deficits. the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process. These factors, along with several economic shocks as well as tax cuts and new spending initiatives, have contributed to successive debt increases over the last decade.

The rapidly expanding debt burden in the US has heightened its vulnerability to future economic shocks. The GG debt-to-GDP ratio is projected to rise over the forecast period, reaching 118.4% by 2025, The debt ratio is over two-and-a-half times higher than the 'AAA' median of 39.3% of GDP. In addition to rising government deficits, it is expected that the general government (GG) deficit to rise to 6.3% of GDP in 2023 from 3.7% in 2022, reflecting cyclically weaker federal revenues, new spending initiatives, and a higher interest burden. The interest-to-revenue ratio is expected to reach 10% by 2025 (compared to 2.8% for the 'AA' median and 1% for the 'AAA' median). The larger deficit will be driven by sluggish GDP growth in 2024, increased interest burden, and an expansion of local government deficits to 1.2%.

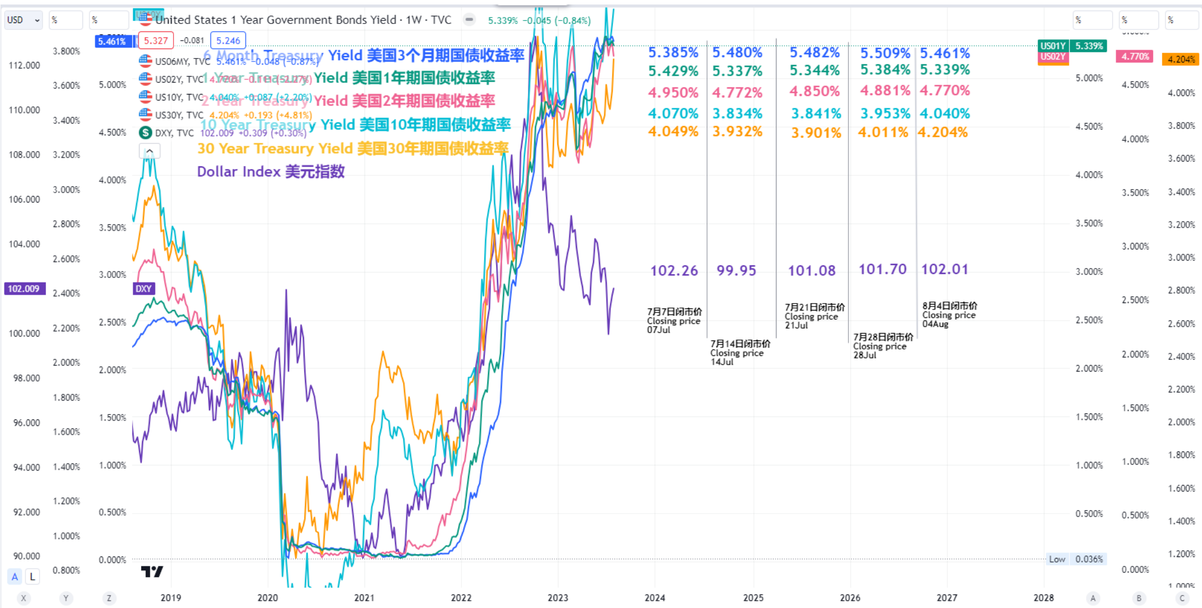
It's worth noting that Fitch also predicts that the Federal Reserve will further raise rates by 25 basis points in September, pushing the federal funds rate to a range of 5.5% to 5.75%. They also point out that due to factors such as tightening credit conditions, weak business investment, and slowing consumption, the US economy may experience a "mild" recession in the fourth quarter of this year and the first quarter of next year.

Fitch's decision has sparked strong reactions from US officials. Former US Treasury Secretary Larry Summers called the decision "completely absurd." US Treasury Secretary Yellen criticized the decision as "arbitrary and based on outdated data." Berkshire Hathaway (BRK.A, BRK.B) CEO Warren Buffett recently stated that the concerns behind Fitch's downgrade decision are valid, but the dollar is the world's reserve currency, and "there are things that people shouldn't worry about, " and "this is one." The decision to downgrade the US rating will not change Berkshire Hathaway's strategy. As Buffett mentioned, "Berkshire bought $10 billion in US Treasurys last Monday. We bought $10 billion in Treasurys this Monday."

2. US Treasury ramps up debt issuance, and US 10Y Treasury yield rises above 4%.

On Wednesday (2 August), the US Department of Treasury issued a new announcement stating that it will sell $103 billion in long-term US Treasury bonds next week, significantly higher than the market's expected $96 billion. Additionally, the US Department of Treasury has raised its net borrowing expectations for the period of July to September to $1 trillion, far surpassing its previous estimate of $733 billion in May. While the impact of the Fitch downgrade is significant, in the broader context of the US economic cycle, this has a positive impact on the supervision and safeguarding of US government bonds. This is especially relevant given the current timing of the US Treasury's large-scale issuance of long-term bonds. The impact of the US Treasury's move on the financial markets even exceeds Fitch's downgrade of US sovereign bonds, a Wall Street hedge fund manager told reporters.

In the past few days, Wall Street has been intensively discussing who will step in to take on the unexpected issuance of US debt by the US Treasury, coupled with the ongoing reduction of the Federal Reserve's balance sheet and the overseas central banks reducing their holdings of US Treasury bonds. As a result of these events, the US 10-year Treasury yield has risen rapidly, breaking through the 4% milestone and reaching as high as 4.20%, nearing the peak of around 4.33% reached on 21 October last year. Previously, the market generally expected that as the current round of Fed rate hikes approaches its end, the US 10-year Treasury yield may fluctuate in the range of 3.5% to 3.8% by the end of this year. However, this large-scale plan to sell US long-term securities could potentially keep the US 10-year Treasury yield above 4%, triggering a short-selling of US bonds and causing a significant amount of capital to exit the stock market and move towards bond investments. This week, the three major US stock indices-the Dow Jones Industrial Average, the S&P 500 Index, and the Nasdaq Index-fell by 1.67%, 2.61%, and 3.48%, respectively. Notably, the S&P 500 Index and the Nasdaq Index, which had been on a continuous upward trajectory for five months, experienced four consecutive days of decline this week, marking their worst weekly performance since the collapse of Silicon Valley Bank in March of this year. This seems to confirm this "transmission effect."



Source: TradingView

As of the market close on 4 August, the long-term US Treasury yields for the 10-year and 30-year bonds have risen from last week's (closed on 28 July) levels of 3.95% and 4.01% to 4.04% and 4.20%, respectively. The short-term US Treasury yields, on the other hand, have exhibited a notable decline. The yields for the 6-month, 1-year, and 2-year Treasury bonds, compared to last week's (closed on 28 July) rates of 5.51%, 5.38%, and 4.88%, have dropped to 5.46%, 5.33%, and 4.77%, respectively.

This unexpected US debt issuance has alerted investors to the possibility that the deterioration of the US fiscal situation may exceed market expectations. A US bond broker told reporters one important reason why the US Treasury is issuing debt beyond expectations is that the US Treasury needs to pay more interest on US bonds. The substantial increase in US bond issuance rates due to the Fed's aggressive interest rate hikes has led to a significant rise in interest payment pressure for US Treasury bonds. Additionally, due to lower-than-expected tax revenues, the US Treasury is resorting to issuing more bonds to fund the payment of bond interest. What's even more troubling is that if the Fed maintains high-interest rates for an extended period and the US Treasury cannot address the issue of increased tax revenues, the scenario of the Fed issuing debt beyond expectations to meet bond interest payments may become the norm.

- *According to estimates from US financial institutions, for every 100 basis points increase in long-term Treasury yields, global private capital demand for US government bonds would increase by 11%. Furthermore, under unchanged conditions, assuming the Fed continues to reduce its balance sheet by approximately $215 billion, it would cause a 10 basis points increase in the 10-year Treasury yield. However, whether this meets the return requirements for private capital's allocation to US bonds remains uncertain.*
- *Barclays Bank's latest report indicates that the US Treasury's increased debt issuance will continue for several quarters. Even if the Fed ends its quantitative easing policy in the first half of next year, the widespread fiscal budget deficit will still require the US Treasury to issue more bonds for funding. If the net borrowing amount by the US Treasury for the fiscal year 2024 approaches $2 trillion, the market would not be surprised.*

Entering the first week of August, two significant events-the "US debt issuance plan" and the "downgrade of the United States' long-term ratings by Fitch"-triggered concerns in the market about the US fiscal outlook, resulting in a simultaneous decline in the US stock market and the bond market. Major global stock market indices followed suit, collectively experiencing a downturn. The potential support for the US stock market and indices lies in the competitiveness of US companies. In the realm of US tech stocks, Amazon saw a cumulative increase of 5.6% this week, driven by quarterly profits significantly exceeding expectations. However, Apple, which has experienced declining revenue over the past three quarters, suffered a significant drop of 4.8% on Friday, with its market value falling below $3 trillion. Refinitiv data indicates that, as of now, 84% of S&P 500 components have reported earnings, with 80% of them surpassing expectations. Coupled with the strong upward momentum in the US stock market, which has significantly exceeded the market's general expectations since the beginning of this year, if the Dow Jones Industrial Average can hold steady at around 35,000 by the end of this year, a rise to 36,000 points is within close reach. The S&P 500 index is currently hovering around 4,500, and a return to around 4,800 is also possible. The Nasdaq Composite Index is currently hovering around 15,000, and the likelihood of returning to its historical high of around 16,000 is substantial.

Here is the weekly record of gains and losses:

- *Dow Jones Industrial Average fell 630 pips (35,680-35,050), a decline of 1.77%. After the release of the non-farm payroll report on Friday, it experienced a V-shaped reversal from an initial rise to a subsequent fall (35,150-35,500-35,050), closing at 35,049 on 4 August. This is a decrease of 387 pips compared to the closing price of 35,436 on 28 July.*
- *S&P 500 Index fell 120 pips (4,600-4,480), a decline of 2.61%. After the release of the non-farm payroll report on Friday, it also experienced a V-shaped reversal from an initial rise*

to a subsequent fall (4,500-4,540-4,475), closing at 4,479 on 4 August. This is a decrease of 103 pips compared to the closing price of 4,582 on 28 July.

- *Nasdaq Index fell 550 pips (15,800-15,250), a decline of 3.48%. After the release of the non-farm payroll report on Friday, it underwent a V-shaped reversal from an initial rise to a subsequent fall (15,310-15,525-15,255), closing at 15,280 on 4 August. This is a decrease of 466 pips compared to the closing price of 15,746 on 28 July.*
- *JP225 Index fell 1,770 pips (33,480-31,710). After the release of the non-farm payroll report on Friday, it experienced a V-shaped reversal from an initial rise to a subsequent fall (31,950-32,300-31,950), closing at 31,952 on 4 August. This is a decrease of 1,169 pips compared to the closing price of 33,121 on 28 July.*
- *AUS200 Index fell 200 pips (7,480-7,280). After the release of the non-farm payroll report on Friday, it also underwent a V-shaped reversal from an initial rise to a subsequent fall (7,285-7,368-7,316), closing at 7,315 on 4 August. This is a decrease of 107 pips compared to the closing price of 7,422 on 28 July.*
- *GER30 Index fell 750 pips (16,525-15,775). After the release of the non-farm payroll report on Friday, it experienced a V-shaped reversal from an initial rise to a subsequent fall (15,800-15,970-15,830), closing at 15,834 on 4 August. This is a decrease of 626 pips compared to the closing price of 16,460 on 28 July.*
- *EU50 Index fell 220 pips (4,495-4,275). After the release of the non-farm payroll report on Friday, it also underwent a V-shaped reversal from an initial rise to a subsequent fall (4,285-4,345-4,304), closing at 4,304 on 4 August. This is a decrease of 161 pips compared to the closing price of 4,465 on 28 July.*
- *UK100 Index fell 290 pips (7,720-7,430). After the release of the non-farm payroll report on Friday, it experienced a V-shaped reversal from an initial rise to a subsequent fall (7,480-7,565-7,509), closing at 7,509 on 4 August. This is a decrease of 160 pips compared to the closing price of 7,669 on 28 July.*
- *TWIX Index fell 50 pips (670-630). After the release of the non-farm payroll report on Friday, it also underwent a V-shaped reversal from an initial rise to a subsequent fall (638-647-641), closing at 642 on 4 August. This is a decrease of 25 pips compared to the closing price of 667 on 28 July.*
- *CHINA50 Index oscillated within a 480-pip range (13,480-13,000-13,240). After the release of the non-farm payroll report on Friday, it fluctuated within the range (13,220-13,290), closing at 13,240 on 4 August. This is a decrease of 147 pips compared to the closing price of 13,387 on 28 July.*
- *HK50 Index fell 1,055 pips (20,375-19,320). After the release of the non-farm payroll report on Friday, it underwent a V-shaped reversal (19,425-19,450-19,425), closing at 19,426 on 4 August. This is a significant decrease of 690 pips compared to the closing price of 20,116 on 28 July.*
- *CHINAH Index fell 430pips (7,020-6,590). After the release of the non-farm payroll report on Friday, it underwent a V-shaped reversal (6,675-6,770-6,690), closing at 6,690 on 4 August. This is a decrease of 214 pips compared to the closing price of 6,904 on 28 July.*

3. US yield curve inversion narrows, and US stock indices may enter a period of decline.

With significant ease of inflationary pressures in the United States, the current round of interest rate hikes by the Federal Reserve is approaching its conclusion. The terminal rate may have already settled around 5.50% to 5.75%. The upward potential for short-term US Treasury yields closely tied to the US benchmark rate is quite limited. On the other hand, the long-term US Treasury yields have been influenced by the US Treasury's "debt issuance plan," causing the 10-year Treasury yield to once again surpass the 4.0% threshold and reach a high of 4.20%. There may still be room for further increases in the future. For most of this year, this data has been fluctuating around 3.5%. In early March of this year, during the US banking crisis led by Silicon Valley Bank, it briefly spiked to around 4.05%. Coupled with the strengthened market expectation of a soft landing for the US economy, the inversion of the long-term Treasury yield rates has finally shown a breakthrough in its narrowing trend this week.

In fact, in the first week of July this year, there was a noticeable change in the inversion of long and short-term US Treasury yields, with a rapid departure from lows and the convergence of inversion starting to occur. As we entered the first week of August, there was a second confirmation of the narrowing inversion of long and short-term US Treasury yields. At the same time, the US stock market underwent a very noticeable downward correction, which also triggered a significant downward shift in the stock markets of other major countries globally. Whether this marks the starting point of a phase of "turning point" change remains to be further observed.

The yield curve inversion of long and short-term US Treasury yields, as observed from the trend charts of "US 10-Year/2-Year Treasury Yield" and "US 10-Year/3-Month Treasury Yield" shown in the following graph, exhibited a very noticeable "narrowing" signal this week. According to a theory, the "narrowing" of the long and short-term Treasury yield curve is considered a signal for the stock market to begin declining. Whether this holds true or not requires further observation. The S&P 500 Index (SPX500) encountered resistance around the 4600 level this Friday and quickly dropped to a low of around 4475 before closing at approximately 4480.

Source: TradingView

The US 10-year and 2-year Treasury yield spread reached around -1.10% on both 8 March and 3 July this year, indicating a deep inversion of about 110 basis points. However, on this Friday (4 August), the yield spread closed at -0.73%, representing a narrowing of 33.6%. Meanwhile, the S&P 500 Index dropped by 2.64% (from 4600 to 4480).

Source: TradingView

The US 10-year and 3-month Treasury yield spread closed at -1.24% on this Friday (4 August), a significant narrowing compared to the deepest inversion of 190 basis points (-1.90%) recorded on 4 May 2023, representing a narrowing of 34.7%. Meanwhile, the S&P 500 Index dropped by 2.64% (from 4600 to 4480).

4. If the US Dollar remains strong, USDJPY could target 145.

1) BOJ tweaked YCC policy, triggering the "butterfly effect" and impacting the US 10-Year Treasury Yield.

Last Friday (28 July), the Bank of Japan decided to tweak YCC policy and allow 10-year Japanese government bond yields to fluctuate within the range of 0.5 percentage point on either side of its 0% target, but it will offer to purchase 10-year JGBs at 1% through fixed-rate operations. This led to a rapid rise in Japan's 10-year government bond yield, reaching around 0.65%. The signal released by the Bank of Japan's adjustment to the yield control curve could be an initial sign of the central bank gradually ending its longstanding ultra-loose monetary policy. This could make Japanese government bonds more attractive, potentially leading investors who previously held US Treasuries to switch to Japanese bonds and sell off US bonds, causing a significant drop in US bond prices. The market's bet on the normalization of Japan's monetary policy may intensify capital flows back to Japan from European and American economies, further pressuring US bond prices. Thus, this week, the US Treasury's announcement of selling $103 billion of long-term US government bonds next week, significantly higher than the market's expected $96 billion, stimulated the US 10-year Treasury yield to soar above 4%. Therefore, the Bank of Japan's YCC policy tweak set off a "butterfly effect" in the financial markets, impacting the US 10-year Treasury yield.

A certain JGB 10-year yield investment model by UBS states that US bond yields and Japanese CPI are key explanatory variables; if US bond yields rise, Japanese bond yields will continue to grow. Last Friday (28 July), the UBS analyst team, led by Masamichi Adachi, released a report stating that if the US enters a recession starting from the fourth quarter (of this year), the Bank of Japan will not adjust the yield target at the 31 October policy meeting nor embark on full policy normalization this year. If the US does not enter a recession in the fourth quarter of this year or ends the recession earlier, the 10-year government bond yield target may be raised, and a rate hike cycle could start in October 2024. Especially if predictions indicate that the US and global economies will remain resilient beyond this year and into next year, the Bank of Japan may adjust the YCC policy again in October. The Bank of Japan will remain cautious until confirming the complete end of the US recession and global economic slowdown. UBS's US team predicts the Fed will conclude rate cuts by September next year. They also anticipate that the Bank of Japan will embark on full policy normalization in October 2024. If the US does not experience a recession or if the downturn is much shorter, the timeframe could be even earlier. The Bank of Japan may implement its first rate hike in October 2024, raising rates from the current -0.1% to 0.1%, followed by 15 basis points in January 2025 and subsequent hikes of 25 basis points in April, July, and October. However, if CPI forecasts for the 2026 fiscal year remain below 2%, policy rates may be kept low at 0.1%, just ending the negative interest rate policy. Regarding balance sheet reduction, the Bank of Japan may discuss this before 2025 and implement it in 2026 or later.

For a very long time, the Japanese yen has maintained a rate of -0.1%. In the financial markets, there are many individuals engaged in derivative trading who often borrow yen at near-zero rates and then invest in other currencies or carry out various financial operations. For example, the most common practice involves borrowing yen at a "0" rate and then investing in USD, GBP, AUD, and CAD. This type of derivative commodity trading involving overseas US dollars and Japanese yen becomes highly vulnerable to changes in the yen. When there's a shift in the yen, the US dollar becomes exceptionally fragile, as yen-related investment portfolios overseas amount to nearly $3.5 trillion, which constitutes two-thirds of Japan's GDP. A substantial amount of yen is circulating overseas in the form of "yen-to-dollar" exchanges, embedded within the global financial system's "dollar liquidity cycle," constantly engaged in trading.

Therefore, any policy changes made by the Bank of Japan, such as abandoning negative interest rates, initiating a yen interest rate hike cycle similar to other developed countries, or relinquishing control over the yield curve control, could result in a shift of yen-related portfolios from foreign assets to Japanese government bonds. This would lead to more funds flowing back to Japan, causing the yen to strengthen against the US dollar, which is a highly probable scenario. UBS's baseline forecast suggests the US will enter a recession starting from the fourth quarter, and the Fed will begin cutting rates from December this year. Therefore, it is unlikely that US bond yields will rise, and the USDJPY may decline. The Bank of Japan may not want to see USDJPY fall below 130, as the companies' average forecast for the fiscal year 2023 is 132.

2) Minutes of the Bank of Japan's monetary policy meeting in July indicate greater flexibility in conducting the Yield Curve Control (YCC).

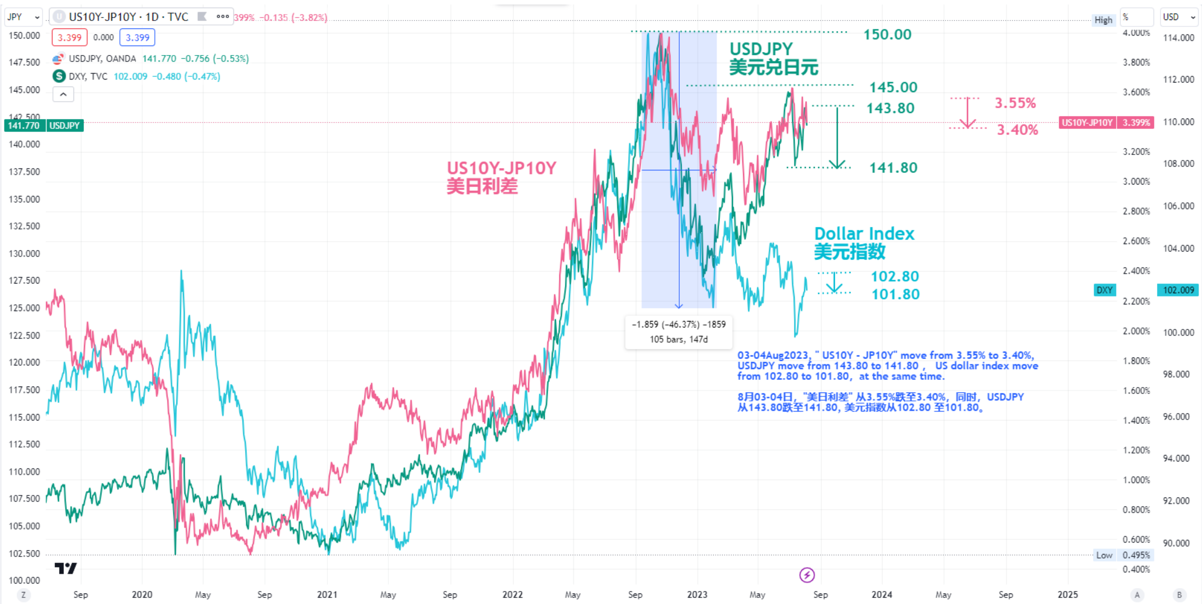
The minutes from the Bank of Japan's July policy meeting, as well as important remarks from the Deputy Governor of the Bank of Japan, Shinichi Uchida, reiterated and clarified the central bank's recent adjustments to the YCC. Deputy Governor Uchida emphasized that the Bank of Japan's decision to adjust the yield curve control (YCC) does not indicate the end of ultra-loose policy but rather aims to continue implementing accommodative measures patiently. As for Japan's inflation, it remains inconclusive whether it is primarily driven by demand-side changes, such as local spending or consumption increases, or factors like wage growth.

Source: TradingView

In the first half of the week, the USDJPY continued its upward trend, reaching a peak of around 143.80. Originally heading towards the 145 level, but on Friday, following the release of weaker-than-expected US July non-farm payroll data, the JPY became the strongest among non-US currencies.

Summary of the Bank of Japan's July monetary policy meeting: Committee members emphasized the importance of continuing the current accommodative policy. In June, the Bank of Japan's committee engaged in intense discussions regarding the possibility of adjusting the yield curve control. Although the committee of nine ultimately decided to maintain the policy unchanged in June, they exchanged views on the possibility of adjusting the Yield Curve Control (YCC) and factors to consider during such adjustments. This set the stage for the Bank of Japan's decision last Friday to loosen its yield control, theoretically allowing the 10-year government bond yield to rise to 1%, surpassing the previously announced 0.5% yield cap. The minutes of the meeting reveal that the debate over Yield Curve Control (YCC) was more intense than what Governor Kazuo Ueda had indicated during the post-meeting press conference in June. His statement at the time and the meeting minutes have reinforced a market perception that the Bank of Japan is finding it challenging to hint at any potential changes to YCC before taking action. One committee member noted the need to avoid triggering a spike in yields due to speculation about exiting from the program. Another member suggested discussing the handling of the YCC policy sooner rather than later. Given increasing upside and downside risks to the price outlook, a member noted that greater flexibility in yield curve control is appropriate to manage these risks. Another member stated that maintaining yield curve control with greater flexibility is necessary until the possibility of achieving the price stability target significantly increases. Ultimately, the Committee unanimously agreed that there was no need to adjust the YCC in June, considering that bond yield curves had become smoother and market functionality had improved.

Key points from the Deputy Governor of Bank of Japan Masayoshi Utada's speech on Wednesday, 2 August: Presently, the risk of prematurely exiting accommodative policies and missing the opportunity to achieve price targets is greater than the risk of tightening policies too late. The Bank of Japan will maintain its policy framework as inflation hitting the price target in a sustained and stable manner has not been observed. The inevitable impact on market functionality is acknowledged due to controlling interest rates. There is significant uncertainty in both the upside and downside of economic and price prospects. Forex volatility is a crucial factor impacting the economy. Adjustments to Yield Curve Control (YCC) are not intended for an exit from the accommodation but rather for continuing the patient implementation of loose policy. It is anticipated that the Japan 10-year government bond yield will not rise to 1%. It is not believed that adjusting YCC will drag down the economy. The Bank of Japan will restrain the excessive upward movement of long-term rates. Thus, the latest measures are expected not to dampen economic activity. The impact of inflation on households is well understood. The risk of premature policy tightening outweighs the risk of keeping policy unchanged. A tweak of the YCC framework is needed for policy continuation. There are no plans currently to raise the YCC yield cap further. Negative interest rates will be increased when economic cooling is necessary, and swift intervention in the government bond market will occur based on the rapid rise of bond yields. It is expected that floating mortgage rates will not be affected. Significant and drastic increases in long-term yields are not expected.



Source: TradingView

Following the announcement by the US Treasury Department this Wednesday of a significant issuance of long-term US government bonds, the US ten-year Treasury yield experienced a rapid surge of over 4% on 3-4 August. Coupled with the recent stabilization of Japan 10-year government bond yield of around 0.64%, the "US10Y-JP10Y" narrowed slightly from 3.55% to 3.40%. Simultaneously, USDJPY dropped from 143.80 to 141.80, and the Dollar Index declined from 102.80 to 101.80. The strengthened positive correlation among these three factors is evident. Consequently, we must continue observing how this enhanced positive correlation *unfolds among these three factors. If the "US10Y-JP10Y" continues to narrow, the upward momentum of the USDJPY may be constrained.*

Since the Bank of Japan's announcement of a greater flexible YCC policy on 28 July, the tendency for the Japanese yen to continue depreciating has become evident. USDJPY continued its upward trajectory this week, reaching a high of around 143.80. However, following the release of the US non-farm payroll data on Friday, the US dollar experienced a decline, causing USDJPY to decrease to about 141.70 by the close of Friday, 4 August. Most non-US dollar currencies consolidated this week, including non-US dollar currencies against the Japanese yen. Here is a summary of the week's fluctuations:

- *USDJPY fluctuated within a 320-pip range (140.70-143.90-141.70), with a 100-pip drop after the release of the non-farm payroll data on Friday (142.70-141.70). Closing at 141.70 on 4 August, compared to 141.15 on 28 July, it still recorded a 55-pip increase.*
- *GBPJPY fluctuated within a 250-pip range (180.80-183.20-180.50), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (180.80-181.45-180.50). Closing at 180.50 on 4 August, compared to 181.35 on 28 July, it recorded an 85-pip decrease.*
- *EURJPY fluctuated within a 250-pip range (155.00-157.50-155.50), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (156.00-156.60-155.95). Closing at 155.96 on 4 August, compared to 155.43 on 28 July, it recorded a 53-pip increase.*
- *AUDJPY fluctuated within a 200-pip range (93.80-95.80-93.00), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (93.20-93.80-93.00). Closing at 93.00 on 4 August, compared to 93.83 on 28 July, it recorded an 83-pip decrease.*
- *NZDJPY fluctuated within a 200-pip range (86.60-88.60-86.35), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (86.50-86.90-86.35). Closing at 86.35 on 4 August, compared to 86.90 on 28 July, it recorded a 55-pip decrease.*
- *CADJPY fluctuated within a 300-pip range (105.10-108.10-105.85), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (106.00-106.50-105.85). Closing at 106.84 on 4 August, compared to 105.54 on 28 July, it recorded a 130-pip increase.*
- *CHFJPY fluctuated within a 230-pip range (161.70-164.00-162.20), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (162.50-162.80-162.25). Closing at 162.25 on 4 August, compared to 162.12 on 28 July, it recorded a 13-pip increase.*
- *SGDJPY fluctuated within a 200-pip range (105.70-107.40-105.70), experiencing a V-shaped reversal drop after the release of the non-farm payroll data (105.75-106.10-105.60). Closing at 105.75 on 4 August, compared to 105.93 on 28 July, it recorded an 18-pip decrease.*

5. The Reserve Bank of Australia holds rates steady, and the Australian dollar weakened.

1) The Reserve Bank of Australia (RBA) maintains the benchmark rate at 4.10% for the third consecutive month.

On Tuesday of this week (1 August), the Reserve Bank of Australia announced its decision to keep the benchmark rate unchanged, maintaining the official cash rate (OCR) at the level of 4.10%. However, it also indicated that to ensure inflation returns to the target level within a reasonable timeframe, there may be a need for some degree of further tightening of monetary policy in the future. This marks the second consecutive month of pausing rate hikes following the RBA's interest rate decision in July this year, adopting a wait-and-see approach. The Reserve Bank of Australia anticipates that inflation is expected to return to the target range of 2-3% by the end of 2025. The central bank has also removed the previous statement mentioning the committee's vigilance regarding the risk of sustained high inflation leading to significant price and wage increases, potentially paving the way for the RBA to conclude its rate hike cycle. The Reserve Bank of Australia might be nearing the end of its tightening phase. Following this news, the AUD/USD quickly declined, reaching a weekly low of around 0.6520, moving further away from the crucial psychological level of 0.6700.

Source: TradingView

However, overall, the AUDUSD remains within the range of the past six months, between 0.6500 and 0.6900. In the short term, a further decline below 0.6500 could open up the range of 0.6500 to 0.6200, whereas a contrary movement could lead to another test of the 0.6600 level.

The recent series of unexpectedly subdued inflation data in Australia has provided additional support for the Reserve Bank of Australia's decision to maintain the status quo. Australia's Consumer Price Index (CPI) for the second quarter of this year slowed from the previous 1.4% growth rate to 0.8% QoQ, below the market expectation of 1.0%. The trimmed mean CPI (YoY) for July also eased from 6.6% to 5.9%, falling short of the market forecast of 6.0% growth. The trimmed mean CPI (QoQ) recorded a growth rate of 1.0%, lower than the market's anticipated 1.1% and the previous 1.2%. Australia's TD Securities Inflation (YoY) for July stood at 5.4%, lower than the previous value of 5.7%. However, there is still a considerable amount of time needed for inflation to return to the target level of 2%. Currently, the interest rate market is betting on the Reserve Bank of Australia making another interest rate hike within the year, followed by an extended period of "standing pat."

Reserve Bank of Australia's monetary policy statement: Continuing to hold steady will afford the committee more time to assess the economic conditions, prospects, and associated risks. In the future, the Committee will remain closely attuned to the global economy, household spending trends, as well as inflation and labor market prospects. The Committee is committed to bringing inflation back toward the target level and will take all necessary actions to achieve this goal. The Committee desires to maintain the gains made in the labor market. While the possibility of a rate hike was considered at the August meeting, the decision to keep rates unchanged was more substantiated. The current policy stance is relatively restrictive in the short term. Tightening policy may further mitigate inflation risks. It is projected that rates will peak at 4.25% by the end of 2023 and decline to 3.25% by the end of 2025. The GDP growth rate is anticipated to be 0.9% at the end of 2023, 1.6% at the end of 2024, and 2.3% at the end of 2025. It is expected that CPI will be 4.1% at the end of 2023, 3.3% at the end of 2024, and 2.8% at the end of 2025. The unemployment rate is projected to be 3.9% by the end of 2023, 4.4% in 2024, and 4.5% in 2025. Global growth over the next two years is expected to be well below average. CPI is projected to be 3.1% in June 2025 and to decrease to 2.8% by December 2025.

The Reserve Bank of Australia (RBA) stated that since May of last year, interest rates have been raised by 4 percentage points. The higher rates are helping the economy establish a more sustainable supply-demand balance and will continue to foster such development. Considering this, along with the uncertainty surrounding the economic outlook, the Committee has once again decided to keep rates unchanged this month. This will provide more time to assess the impact of the rate hikes thus far and the economic prospects. Despite companies reporting some alleviation of labor shortages, job openings, and advertising recruitment demands remain high. As economic and employment growth is expected to be below trend, the unemployment rate is projected to rise gradually from the current 3.5% to around 4.5% by the end of next year. Wage growth has accelerated due to tight labor market conditions and high inflation. Overall, as long as productivity growth accelerates, wage growth remains consistent with the inflation target. The pause in rate hikes will provide time to assess their effects, given significant uncertainty in the lagging and consumption aspects. Further policy decisions will depend on data. Recent data aligns with the prediction of inflation returning to the 2-3% target range within the forecast period, alongside ongoing growth in output and employment. Bringing inflation to the target level within a reasonable timeframe remains the Committee's primary task. Mid-term inflation expectations are crucial in maintaining consistency with the inflation target. Wage growth has accelerated in response to the labor market. Inflation has come down but remains elevated. The expectation is for below-trend economic growth to persist for a period. Recent data suggests a return of inflation to target. Many mortgage holders are experiencing painful financial tightening, and consumer spending has significantly slowed.

- *Goldman Sachs has revised down its peak rate expectation for the RBA from 4.6% to 4.35%.*
- *Westpac: The RBA's Official Cash Rate (OCR) has likely reached a peak of 4.1%.*
- *Sean Langcake, Head of Macroeconomic Forecasting at BIS Oxford Economics, stated that the RBA's decision to keep the OCR unchanged at 4.1% for a second consecutive month indicates that the bank believes the current rate-hiking cycle has sufficiently dampened demand growth and inflation. Given the rapid cooling of inflation compared to expectations, it seems unlikely that the RBA will hear more convincing reasons for further rate hikes at the policy meeting on Tuesday. He added that the RBA may have reached the peak of its cash rate cycle, and the pause in rate hikes may continue until 2024.*
- *Reuters: The RBA is expected to raise the cash rate to 4.35% in the fourth quarter of 2023. Among 29 economists, 24 indicated that the RBA will keep the cash rate unchanged at 4.10% on 5 September.*

2) China's announcement of terminating the anti-dumping and anti-subsidy tariffs on imported barley has provided limited support for the Australian Dollar's momentum.

China announced that starting from this Saturday, 5 August, it will terminate the anti-dumping and anti-subsidy measures on Australian barley, marking the latest sign of improvement in the relationship between China and Australia. China's Ministry of Commerce announced on 18 May 2020 that it would impose anti-dumping and anti-subsidy duties on imported barley originating from Australia for a period of five years. The official website of China's Ministry of Commerce announced on Friday, 4 August, the termination of these measures. The Australian government also hopes to leverage this decision to lift the barley tariff as an opportunity to persuade China to fully lift trade restrictions on other Australian goods. Australia's Minister for Trade, Don Farrell, stated on Friday that they would use this process as a template to address wine export issues. As two important trading partner countries, China and Australia are currently working to normalize their business relationship. This news could be a significant positive development for the Australian Dollar. However, the rise of the Australian Dollar will primarily depend on when the US Dollar truly begins its decline and the depreciation rate of the US Dollar.

Since February of this year, the Australian Dollar has shown an overall tendency towards depreciation, falling from its high point of 0.7150 this year to around 0.6500, marking the year's low for the second time in recent months, largely influenced by China's slow recovery in the first half of this year and subdued global demand. Moreover, global demand may continue to be weak in the second half of this year as the US might enter a mild recession, and the Eurozone is currently sluggish. The Chinese government has stated that it will no longer implement large-scale demand-stimulus measures in the second half of the year, opting for limited, targeted actions such as local housing loan relaxation to boost the real estate market and extending opening hours for museums and amusement parks to stimulate supply-side consumption. This limited policy support suggests that China's recovery may continue to be uneven, imbalanced, and prolonged.

6. Short-term risks

From a short-term perspective, the US Dollar appears to have ongoing upward momentum. Recent hawkish statements from multiple Federal Reserve officials have provided continuous support for the Dollar Index. President of the Federal Reserve Bank of Chicago Charles Evans, in an interview on Tuesday, 1 August, criticized market expectations for rate cuts, stating that any rate cuts will be in the distant future. President of the Federal Reserve Bank of Atlanta Raphael Bostic also mentioned that the basic outlook is no rate cuts before the second half of 2024 and a firm stance not to change policy direction before achieving the 2% inflation target.

Amid sustained production cuts by major oil-producing countries, oil prices surged in July, reaching the highest levels since April of this year. Brent crude and West Texas Intermediate (WTI) crude recently reached their yearly highs at around 86.00 and 82.00, respectively, driving energy stocks higher. The mid-term outlook for oil prices remains positive, but in the second half of this year, global economic growth may continue to stagnate, and short-term risks to oil prices have not been eliminated. It is worth noting that despite the significant increase in oil prices in July, commodity currencies such as the Canadian Dollar (CAD), Australian Dollar (AUD), and New Zealand Dollar (NZD) have been relatively stagnant, fluctuating within a range of 200-300. Caution is needed to monitor the possibility of another surge in oil prices, which could contribute to inflationary pressures. Looking ahead, it is important to continue monitoring the performance of US inflation-related economic data and the statements of Federal Reserve officials, as these factors will influence the short-term direction of the US Dollar.

In the Euro-American region, particular attention should be given to the US Consumer Price Index (CPI) data for July, scheduled to be released on Thursday, 10 August, as well as the US Producer Price Index (PPI) data for July, scheduled for release on Friday, 11 August. In the Asia-Pacific region, the focus should be on China's Consumer Price Index (CPI) data for August, set to be released on Wednesday, 9 August, and Japan's second-quarter GDP data, scheduled for release on Friday, 10 August.

Furthermore, attention should be directed to Federal Reserve Chairman Jerome Powell's potentially significant remarks at the Jackson Hole Economic Policy Symposium at the end of this month, on 27 August. The Jackson Hole Economic Policy Symposium is an annual important global central banking conference where Chairman Powell often delivers crucial policy signals. It is expected that Powell will not reveal signals of easing during this meeting, but if he acknowledges that the peak of this round of rate hikes has been reached or is near, it will imply the end of the current tightening cycle of the US dollar. Investors will be quick to place bets on the future direction of Federal Reserve policy. At that point, the US dollar could potentially initiate a more pronounced downward trend at any time!

Sandy Wang,

5 August 2023-6 pm SGT