Analysts

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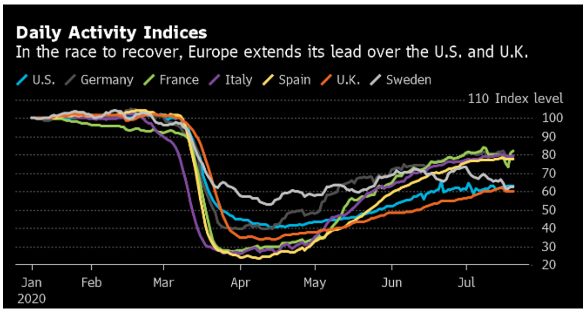
Basic Information

Real GDP (€ Trillion)	14.45 (2021)
M2 (€ Trillion)	14.92 (Mar-22)
CPI	115.9 (Mar-22)
PPI	147.2 (Mar-22)
Con. Confidence	-21.9 (Apr-22)
Currency	Euro (EUR)

Source: Statista, Trading Economics

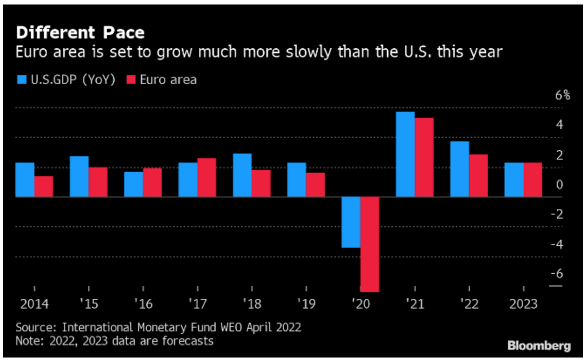
Chart info

Figure 1: Initially set to outpace its peers…



Sources: Bloomberg, Google, Moovitapp.com, German Statistical Office, BloombergNEF, Indeed.com, Shoppertrak.com, Opportunity Insights

Figure 2: … but the war eventually led to forecasted underperformance of European economic growth



Sources: Bloomberg, IMF

Overview of the European Union

- The European Union (EU) is an economic and monetary integration of 27 European member countries as of January 2020, which marked the formal exit of the U.K. from the trading bloc. Of these 27 members, 19 adopt the Euro (€) as their official currency. These 19 countries make up a subset of the EU, which is known as the Eurozone or Euro area (its official name). The Euro is the world's second reserve currency, after the U.S.'s greenback.

- The Central Bank of the EU is the European Central Bank (ECB), which remains chaired by Christine Lagarde – who took over Mario Draghi in 2019. The ECB, as part of the bigger Eurosystem, is tasked with ensuring price stability by managing and implementing a single monetary policy across the Eurozone, as well as by managing foreign reserves.

- The European Commission is a legislative body that develops policies, laws, and funding programmes for all 27 members of the EU, and Ursula von der Leyen has held the presidency of the Commission since 2019. The REPowerEU plan was proposed by the Commission in March 2022 to cut the region's dependence on Russian gas, following the Russian invasion of Ukraine that also led to high and volatile energy prices.

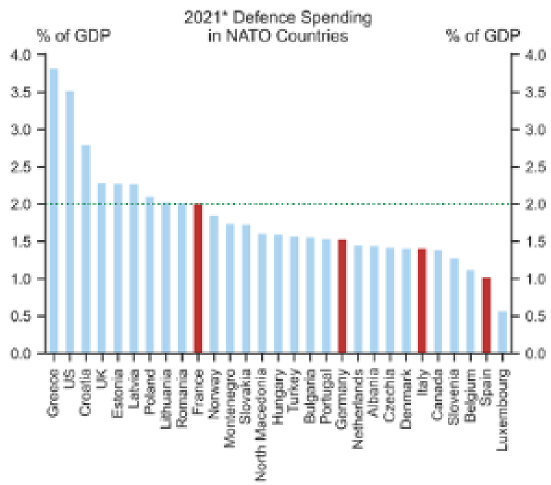
- Among the developed economies, the Euro area has been entrenched in a decade of sluggish growth and low inflation. This was due to a combination of weak productivity growth and demographic factors. Europe was initially set to outperform the U.S. in its post-pandemic recovery (Fig. 1), but the war eventually posed a major setback to this development that led to downward revisions in growth forecasts (Fig. 2).

- The Services sector remains the growth engine of the EU, making up around 70% of GDP, composing of industries like R&D, business professional & technical services, transport, travel and ICT. Manufacturing is the secondary driver of growth in the European economy, making up 25% of GDP with its main export products being machinery & equipment, pharmaceutical products, and motor vehicles.

- There are 4 main economies within the EU – Germany, France, Italy and Spain, which each contribute 25%, 17%, 13% and 9% to EU GDP respectively in 2020. This focus of this report will therefore be on these 4 countries.

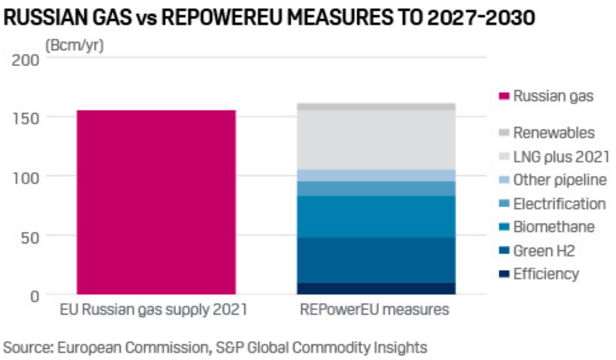
- The main trading partners of the EU are primarily the U.S., the UK and China. In 2021, the U.S. took the pole position as the EU's biggest export partner (18.3%), followed by the UK (13%) and China (10.3%). In terms of imports, China is the EU's largest partner (22.3%), followed by the U.S. (11%) and Russia (7.7%).

Figure 3: Defence Spending in NATO Countries



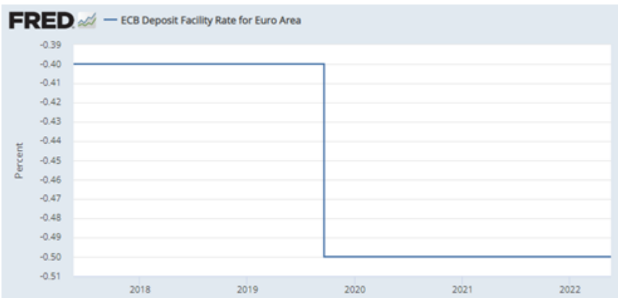
Sources: Goldman Sachs Global Investment Research, Haver Analytics, NATO

Figure 4: REPowerEU plan in detail



Sources: European Commission, S&P Global Commodity Insights

Figure 5: ECB Deposit Rate



Sources: European Central Bank, St. Louis Fed

Summary of Events in the Past 6 Months

Fiscal Policy

- Across EMU4, tax cuts and rebates have been implemented to cushion the impact of rising energy prices on households. Goldman Sachs Global Investment Research estimates the fiscal impact of these measures to total €53 billion.
- Led by Germany, there have been increasing talks in Europe on boosting military expenditure in order to counter security threats. Of the EMU4 countries, only France has hit NATO's requirement of spending 2% of GDP on defence, leaving significant room for an increase in defence spending (Fig. 3).
- The overall additive costs of the fiscal measures adopted is set to cause the public deficit across the EMU4 by 1.1% of GDP, while providing a 0.5% boost to the fiscal growth impulse (Fig. 15). The European Commission is likely to propose a continued suspension of the EU's budget rules in 2023 given the increase in spending and deteriorating growth outlook with the Ukrainian crisis.
- REPowerEU is the European Commission's plan for a sustainable energy plan that is independent of Russia, in order to improve energy security. With aims to reduce Europe's dependency on gas from Moscow by two-thirds this year, renewables headline their plan for substituting out Russian gas (Fig. 4) while helping progress towards their climate goals simultaneously. In the longer-term, the EU is also planning for an additional 50bcm worth of US LNG imports annually, until 2030 or later.

Monetary Policy

- The ECB stuck to its announced plan of ending net purchases of securities under the Pandemic Emergency Purchase Programme (PEPP), the last of which occurred in early April 2022. Since the launch of PEPP by the ECB, the total net purchases of Eurozone securities has added up to €1.718 trillion.
- The order of operations for ECB policy tightening, termed as sequencing, has been made clear by ECB chief Lagarde multiple times. Net asset purchases will have to come to an end before the key deposit facility rate is raised. In the April ECB meeting, the ECB indicated that net purchases under the Asset Purchase Programme (APP) should come to an end by early Q3 2022.
- In a press conference in early May, Lagarde confirmed that a July rate lift-off was possible, but maintained that hikes will be gradual. Given such information, we think that the ECB will hike interest rates in 25bp intervals to bring the policy rate from -0.50% to 0.00% by end-2022 (Fig. 5), with the first hike possibly coming as early as July.

- We think that it is increasingly likely that the ECB will have to launch a separate facility dedicated towards containing peripheral spreads, as the structurally weaker peripheral economies (Spain and Italy, among others) will face even tighter financial conditions and gloomy economic outlooks with monetary policy tightening into a global growth slowdown. This could provide opportunities in the rates space, where astute traders can place directional bets on yield spreads and Credit Default Swaps (CDS).

Geopolitical Events

- Russia invaded Ukraine on February 24th, primarily in the name of ensuring its national security. Over the course of these few months, some of the initial retaliatory actions from the West include the Germans putting a halt to the Nord Stream 2 pipeline project, the exclusion of select Russian banks from the SWIFT system, and a US ban on Russian oil and gas. However, only in April did the EU make its first move targeting Moscow's energy revenues by announcing a full ban on Russian coal to be in force by mid-August.
- Historically neutral, Sweden and Finland recently confirmed their plans to join NATO in a significant realignment of alliances, deepening geopolitical fault lines with Russia and its allies (including Turkey). This is a key development in the war that is still unfolding, and we are closely watching Putin's response. We think this conflict has become considerably more fluid and tensions may in fact escalate further, and therefore the risk environment may not turn around as soon as optimists may expect.

European Union

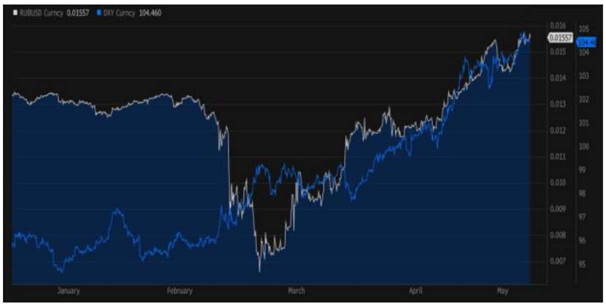
Putin's legacy on the line

Even prior to the invasion on February 24, our Semester 1 report had flagged the downside risk posed by a potential flare up in geopolitical tensions. As it turned out, Putin's choice of actions has almost completely transformed our outlook for the European economy – we originally expected the European Stoxx 50 Index to outperform the S&P 500 in 2022, but we now see the probability of a recession in the EU to be not-insignificant – and, more importantly, led to tremendous humanitarian damage.

There were many reasons for the invasion circulating around the media, but in summary we attribute it to the Kremlin's interests in having a "neutral" Ukraine – one that is prohibited from joining the North Atlantic Treaty Organisation (NATO), with parts that are "fundamentally parts of Russia" being liberated, and whose chokehold on Crimea is removed as the region was getting very costly for Russia to maintain control over. In essence, it boiled down to Putin wanting to ensure national security at all costs.

Over the course of these few months, some of the initial retaliatory actions from the West include the Germans putting a halt to the Nord Stream 2 pipeline project, the exclusion of select Russian banks from the SWIFT system, and a US ban on Russian oil and gas. However, only in April did the EU make its first move targeting Moscow's energy revenues by announcing a full ban on Russian coal to be in force by mid-August. The ruble also collapsed initially before roaring past pre-invasion levels, after a flurry of capital controls imposed by the central bank synthetically spurred a rally in the currency against the dollar – even as the greenback saw significant strength as well over the same period (Fig. 6).

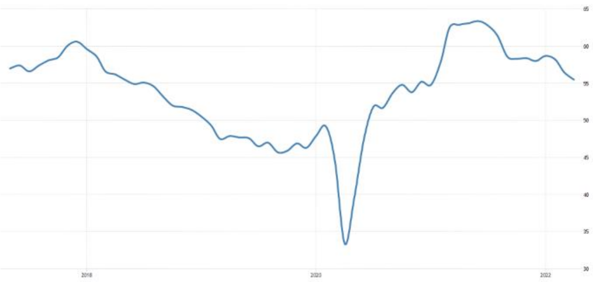
Figure 6: RUB/USD *(white)* **vs DXY** *(blue)*



Source: Bloomberg

With their statements of intent in mid-May, the historically neutral Finland and Sweden also look set to formally request NATO membership in the face of threats from Moscow and opposition from Russian ally Turkey. Accordingly, we think this conflict has become considerably more fluid and tensions may in fact escalate further, and therefore the risk environment may not turn around as soon as optimists may expect. Accordingly, commodity prices (European TTF gas, oil, and certain agricultural products that are key Russian and/or Ukrainian exports) are likely to continue trading in an elevated range, with risks skewed to the upside given that the conflict could potentially extend into winter with supplies not yet sufficiently filled to meet heating demand.

Figure 7: Euro area Manufacturing PMI



Source: Trading Economics

Lower risk of stagflation to round up Q2, but second-round effects may still be looming in the second half of 2022

The narrative in early 2022 was a story of Covid-induced restrictions in place since late 2021 up till mid-February, which contributed to a marginally weaker Q1'22 GDP print in countries like France (whose economy was hampered by lacklustre consumer spending, the traditional driver of French growth). However, this also meant that the subsequent boom upon the easing of restrictions was always going to be a robust one with pent-up demand being released, particularly in the services sectors. Accordingly, April PMI data handily beat estimates that were looking for a slowdown in economic activity, catalysed by higher prices and further exacerbated by the war. Instead, composite PMI surprisingly rose to a 7-month high, although the pace of growth in the manufacturing sector has dipped a fair bit.

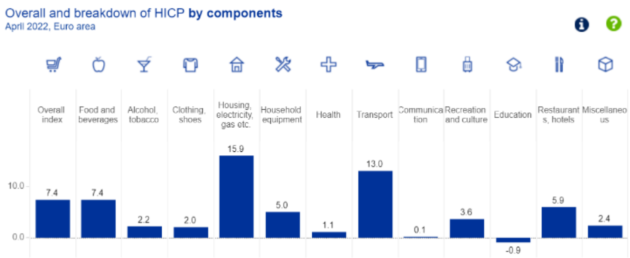
It may still be the case that growth weakens in the latter half of the year, however, due firstly to higher prices eroding purchasing power and causing consumers to put off spending. Should the risk-off environment also persist on the back of persistent conflict, firms are also likely to reassess their investment decisions – especially as funding costs rise with tighter financial conditions. Lastly, sanctions on Russia (EU's 5th largest export destination, 4.1% of total 2021 exports) are likely to take a toll on Europe's exports value while energy imports remain roughly constant albeit from different sources, causing net exports to fall. In sum, the outlook for European growth in 2H'22 appears to be rather bleak.

Focusing on rapidly climbing prices, these were already a concern for consumers and monetary policymakers alike even prior to the war, particularly as January's Harmonised Index of Consumer Prices (HICP) figure clocked in 5.1% higher than the year before, substantially higher than consensus estimates. Prices were boosted by already soaring energy prices due to tight inventories, post-lockdown demand, and global shortages of certain raw materials and products. As of writing we are currently looking at 7.5% in April, with the potential to go higher for longer as there are ongoing pipeline pressures from rising commodity prices, ranging from energy to food products. The ECB reportedly plans to double its estimate for inflation to 6.1% this year. Producer prices are also very strong, with the German Producer Price Index (PPI) for industrial products up 33.5% in April year-on-year – the highest reading ever recorded (Fig. 9).

Meanwhile, unemployment is headed right in the opposite direction coming in at a record low 6.8% in March. This indication of rapidly diminishing slack in the economy flashes some early signs of wage growth (1.5% YoY in 4Q'21) and second-round inflation effects, which continues to put the ECB in a precarious balancing act between keeping the economy from overheating while simultaneously not derailing the economic activity that Europe sorely needs to avoid a second "lost decade".

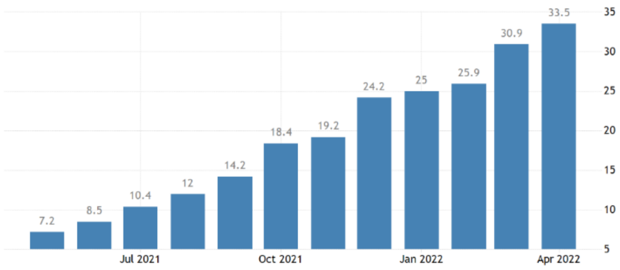
Altogether, these factors are playing out a scenario reminiscent of the oil shock in the 1970s, where the only solution to higher wages was higher prices, and higher prices beget higher wages i.e. the formation of a wage-price spiral. However, it is higher inflation expectations rather than higher wage growth that have historically led to more persistent second-round effects. Therefore, for a gauge of whether the stagflation narrative may hold water, we think ECB policy remains the focal point to watch as we need a tighter and more restrictive monetary policy environment to rein in long-term inflation expectations, in spite of all the talk that inflation is mostly the product of supply chain disruptions (that then boil down to the disruption to activity in China).

Figure 8: EU HICP breakdown (April 2022)



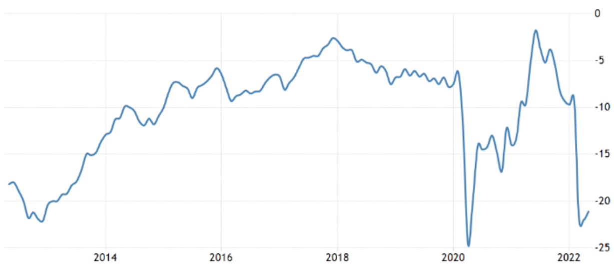
Source: ECB

Figure 9: Germany Producer Prices Change



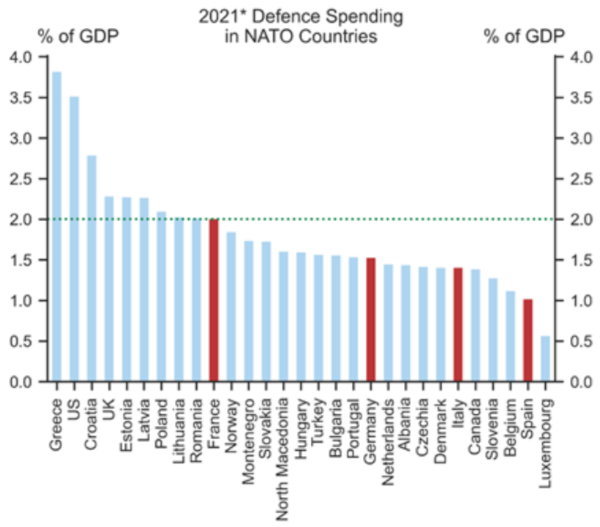
Source: Trading Economics, Federal Statistical Office

Figure 10: Euro area Consumer Confidence



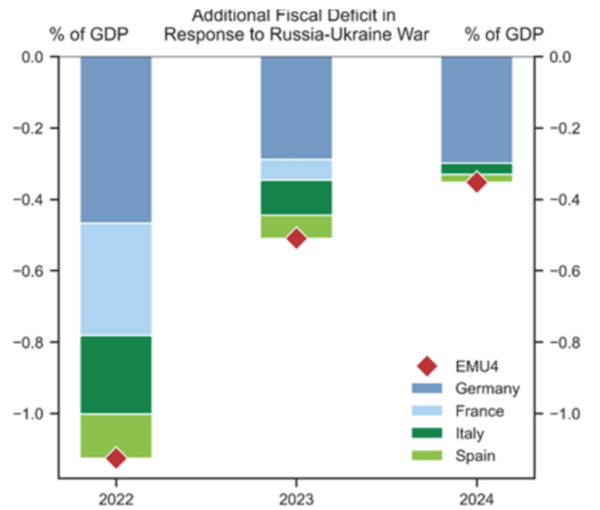
Source: Trading Economics, European Commission

Figure 11: Defence Spending in Europe



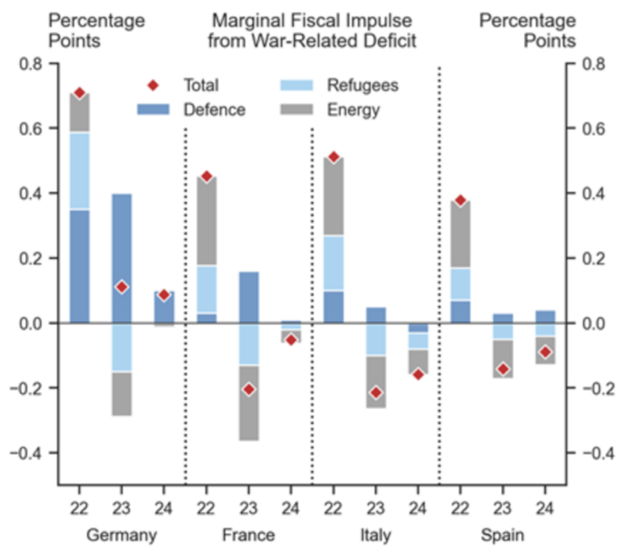
Source: Goldman Sachs, NATO

Figure 12: Increase in Fiscal Deficit



Source: Goldman Sachs

Figure 13: Fiscal Growth Impulse



Source: Goldman Sachs

Fiscal Policy

The Ukrainian crisis has caused a surge in energy prices, especially in Europe, which has a high dependence on Russian energy exports. Even prior to the war, some European governments had already begun adopting fiscal measures to cushion the impact of rising energy prices on households. Across EMU4, tax cuts and rebates have been implemented. Goldman Sachs Global Investment Research estimates the fiscal impact of these measures to total €53 billion.

Concerns over the security of Europe have come to fore with the continuing conflict in Ukraine. Led by Germany, there have been increasing talks in Europe on boosting military expenditure in order to counter security threats. Of the EMU4 countries, only France has hit NATO's requirement of spending 2% of GDP on defence, leaving significant room for an increase in defence spending (Fig. 11).

Large numbers of Ukrainian refugees have arrived in EU countries as they flee conflict in their homeland. The EU had activated the Directive on Temporary Protection, granting temporary residence permits to any refugee from Ukraine for at least a year. The cost of receiving and housing these refugees will cost host countries between €900 - €1200 a month, thus adding to EU members' deficits.

The overall additive costs of the fiscal measures adopted is set to cause the public deficit across the EMU4 to increase by 1.1% of GDP in 2022 (Fig. 12), while providing a 0.5% boost to the fiscal growth impulse (Fig. 13). The European Commission is likely to propose a continued suspension of the EU's budget rules in 2023 given the increase in spending and deteriorating growth outlook with the Ukrainian crisis. Under the rules set out in the Stability and Growth Pact, national fiscal deficits are limited to 3% of GDP and public debt to 60% of GDP. Current forecasts show that France, Italy and Spain will all face challenges bringing the deficit back down within the limit (Fig. 14).

European Central Bank

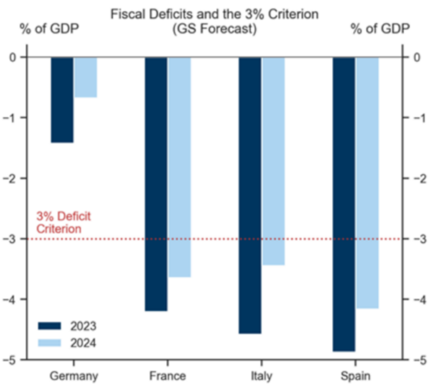
The Pandemic is Over, so is PEPP

In early April 2022, the last net purchases of securities under the Pandemic Emergency Purchase Programme (PEPP) occurred. Since the launch of PEPP by the ECB, the total net purchases of Eurozone securities added up to €1.718 trillion. The total net purchases of securities have adhered well to the Eurosystem capital key (Fig. 15), suggesting that the ECB has not seen an active need to utilise the flexibility in country allocation of net security purchases. This indicates that there has not been excessive stress on any particular economy.

Pivot - Or Pirouette?

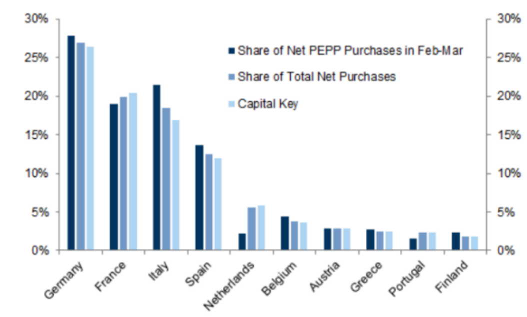
Across global economies, persistent inflationary pressures have led to elevated volatility in the rates market. Even in the Eurozone, with growth stagnating, the market has priced in nearly 80bps of

Figure 14: Project Fiscal Deficits in EMU4



Source: Goldman Sachs

Figure 15: Total Purchases under PEPP

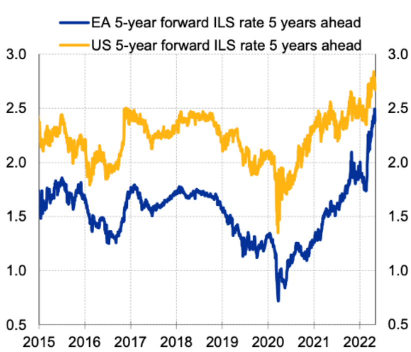


Source: Goldman Sachs, Haver Analytics, ECB

Figure 16: EURIBOR Dec '22 Contract

Source: TradingView

Figure 17: EUR 5y5y Inflation Swap



Source: Bloomberg, Refinitiv, ECB

hikes by December 2022 – the December Euribor futures contract traded as low as 99.205 in late May (Fig. 16). Numerous communications from the ECB have emphasised the importance of monetary policy to anchor medium-to-long term inflation expectations in order to bring inflation back to the 2% target. The 5y5y inflation swap prices the 5-year average inflation, 5 years from now in the Eurozone at 2.5%, above the 2% target of the ECB (Fig. 17). There is a real danger that inflation expectations in the Eurozone will become unanchored should the ECB not tighten policy sufficiently.

Hiking less than market expectations may lead to a deterioration in the inflation outlook. Firstly, with real rates deeply negative, a dovish ECB will fail to sufficiently dampen demand. Secondly, a dovish ECB will lead to a weaker Euro, leading to higher imported inflation. Since the start of the Ukrainian crisis, there has been strong downward pressure on the EUR/USD FX rate, driven simultaneously by a flight to safety to the dollar and a diminished Eurozone growth outlook. The EUR/USD FX rate traded as low as 1.0355 on 12 May 2022 (Fig. 18). With commodity prices being the significant contributor to Eurozone inflation, the effect of a weaker Euro on inflation will be strong. Bank of France governor Villeroy affirmed these concerns and stressed that ECB officials will be monitoring the strength of the Euro, as an overly weak Euro will run contrary to the ECB's price stability objective.

The order of operations for ECB policy tightening, termed as sequencing, has been made clear by President Lagarde multiple times. Net asset purchases will have to come to an end before the key deposit facility rate is raised. In the April ECB meeting, the ECB indicated that net purchases under the Asset Purchase Programme (APP) should come to an end by early Q3 2022. In a press conference in early May, Lagarde confirmed that a July rate lift-off was possible, but maintained that hikes will be gradual - that implies only hikes of up to 25bp are on the table. Given such information, we think that the ECB will hike interest rates from -0.50% to 0.00% by end-2022, with the first hike possibly coming as early as July.

Whatever It Takes 2?

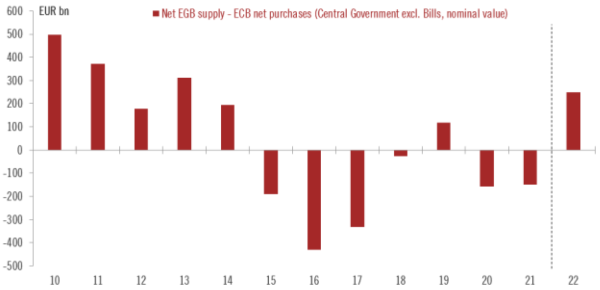
With the conclusion of APP, the net supply of European Government Bonds (EGBs) is set to rise sharply in 2022 (Fig. 19). Net increase in bond supply is projected to be at €277 billion in 2022, up by €66 billion since the start of the Ukrainian conflict. While the European Commission expects that the budget deficit will decline from 5.1% of GDP in 2021, to 3.7% this year and 2.5% in 2023, it is of little solace – since net issuance is still increasing, only that the rate of increase is lowered. This will put pressure on the borrowing capacity of peripheral countries and raise their debt service costs.

Even in Triple-A rated Germany, German 10-year Bund yields hit a 8-year high in early May at 1.189% (Fig. 20). The key Bund-BTP spread rose as high as 206.9 bps, signalling divergence in performance between core and periphery economies and highlighting significant financial stability concerns within the Eurozone (Fig. 21). We expect the Bund-BTP spread to widen

Figure 18: EUR/USD FX Rate

Source: TradingView

Figure 19: EGB Net Supply



Source: Pictet

Figure 20: German Bund Yields

Source: TradingView

Figure 21: Bund-BTP Spread

Source: TradingView

further in the coming months as growth continues to disappoint and inflationary pressures remain high.

We think that it is increasingly likely that the ECB will have to launch a facility dedicated towards containing peripheral spreads, as the structurally weaker peripheral economies will face even tighter financial conditions and economic outlooks with monetary policy tightening into a global growth slowdown. This could provide opportunities in the rates space, where astute traders can place directional bets on yield spreads and Credit Default Swaps (CDS).

Heat them up!

REPowerEU: Europe's ex-Russia sustainable energy solution

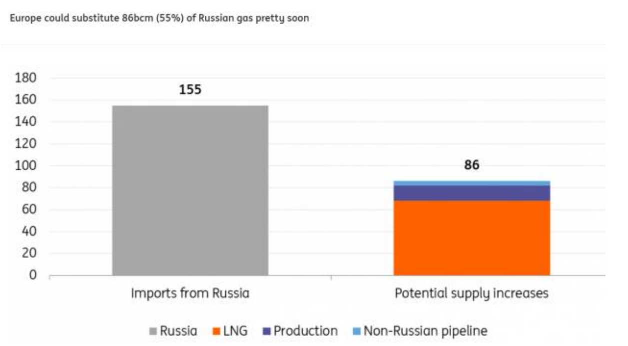
Diversification is perhaps one of the most commonly preached principles of investing, but when it comes to energy sources for Europe, their dependence on Russian gas supply is unacceptably high – around 40% of the EU's gas needs came from Russia prior to the war, amounting to about 155 billion cubic meters (bcm). Summer typically sees the refilling of reserves in anticipation of heating demand in winter, which makes it pertinent to find a solution to energy security – and fast. Both European natural gas and LNG stocks are currently above levels during the same period last year, but Russia has already cut off supply to Bulgaria and Poland over their refusal to pay in rubles, with indication of more to come against countries that have imposed sanctions or which reject Russia's payment scheme.

Although the contracted gas flows from Russia held up well during the early stages of the war, Ukraine has now blocked some Russian flows to Europe through a major gas transit route as of writing, to which Russia responded by imposing sanctions on European subsidiaries of state-owned Gazprom – including Gazprom Germania, Germany's trustee that secures gas supplies on her behalf. European TTF gas prices understandably spiked as a result, and pressure on European leaders to secure alternative gas supplies continue to mount. The silver lining amidst these worries is the energy-grid flexibility that allowed enough flow to continue, as alternative pipeline routes sprung up within hours.

Enter: REPowerEU, the European Commission's plan for sourcing energy with Russia removed from the equation (Fig. 22). With aims to reduce Europe's dependency on gas from Moscow by two-thirds this year, renewables headline their plan for substituting out Russian gas while helping progress towards their climate goals simultaneously.

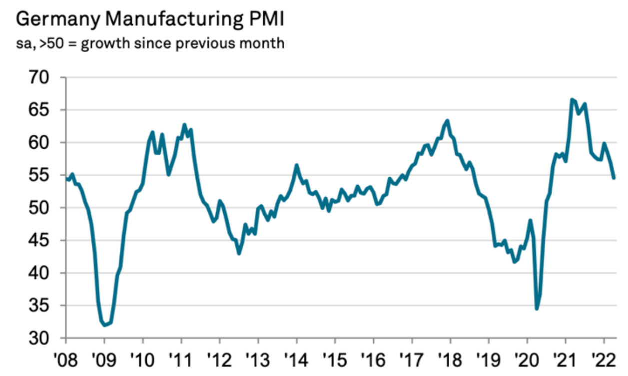
German politicians have pledged to completely cut out Russian gas by mid-2024, while US officials have committed to delivering at least 15bcm of extra liquefied natural gas (LNG) to Europe this year on top of the 22bcm in 2021. In the longer-term, the EU is also planning for an additional 50bcm worth of US LNG imports annually, until 2030 or later.

Figure 22: Energy source distribution under REPowerEU



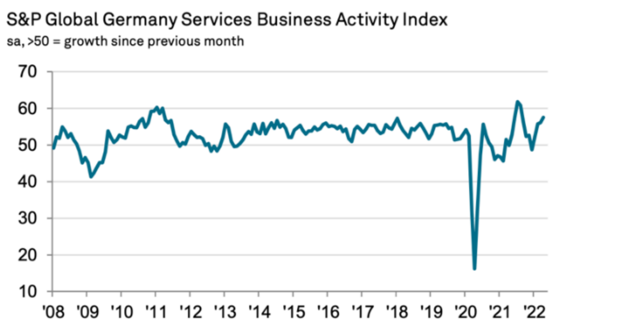
Source: ING Research

Figure 23: German Manufacturing PMI



Source: S&P Global

Figure 24: German Services PMI



Source: S&P Global

Figure 25: German CPI and PPI

Source: Bloomberg

Germany

War Hampens German Recovery

The German economy is driven primarily by services, which account for 68.6% of GDP, and secondarily by manufacturing, which accounts for 30.7% of GDP. Broadly speaking, both manufacturing and services have experienced a robust recovery and are on track to return to pre-pandemic levels. German manufacturing PMI (Fig. 23) indicated that the manufacturing sector (which in fact started way before the pandemic, in January 2019) has been expanding since bottoming in July 2020, while German services PMI (Fig. 24) shows that it has also been growing since August 2020. While there has been a noticeable slowdown in the rate of growth in manufacturing due to the geopolitical and economic uncertainty resulting from the Ukrainian crisis, the services sector continued a robust recovery, as the services sector is less exposed to external headwinds and services that were previously subject to pandemic-related restrictions continue to grow.

Overall, due to supply chain bottlenecks and uncertainty generated by the Ukrainian crisis, the German economy grew by a mere 0.2% in Q1 2022. However, this has helped to close the gap toward pre-pandemic levels to within 0.9%. In late April, the German government reduced its projections of growth in 2022 to 2.2%, down from the 3.6% it expected in January prior to the Ukrainian crisis. As a result of the Ukrainian crisis and the consequent energy insecurity, German YoY inflation in April hit a 4-decade high of 7.4%. The unemployment situation improved, however, and unemployment further declined by 13,000 in April to the pre-pandemic level of 5.0%.

Red Army Descends on Berlin

Of all the Eurozone economies, the German economy is the most exposed to the Ukrainian shock. This is because of Germany's heavy dependence on Russian gas for energy. The export-driven German economy faces headwinds from 2 fronts: Firstly, relatively higher inflation in Germany damages the price competitiveness of its exports. Secondly, the waning global growth reduces demand for German exports. Without a resolution to the Ukrainian crisis, German energy supply will remain vulnerable and the prevailing uncertainty will continue to hold back business confidence. In April, the German Consumer Prices Index rose by 7.4% and Producer Prices Index (PPI) surged by a record 33.5% (Fig. 25). This is set to depress German firms' margins, negatively impacting earnings growth.

Revitalising the Prussian Tradition

Following the Ukrainian crisis, German chancellor Olaf Scholz pledged 100 billion euros to a special fund to modernise the German military, and committed to spending 2% of GDP on defence in the coming years, in line with NATO requirements. To the extent that this new spending is domestic and debt-financed, it will provide a boost to German manufacturing. Indeed, German defence stocks such as Rheinmetall and Hensoldt have rallied strongly since this announcement.

France

Welcome back, President Macron

The French presidential election was one of the events that generated more interest from market participants aside from the ongoing war and energy crunch, and it eventually turned out to be a benign event with incumbent president Macron's re-election following a close contest with old foe Marine Le Pen. Nonetheless, Macron won by a marginal 58.5% compared to his 66.1% landslide victory in 2017, and 62% of voters did not vote for him when factoring in those who abstained. These indicators point towards an electorate that is increasingly resentful of the existing political (lack of opposition presence) and social system, even if not directly approving of far-right candidate Le Pen.

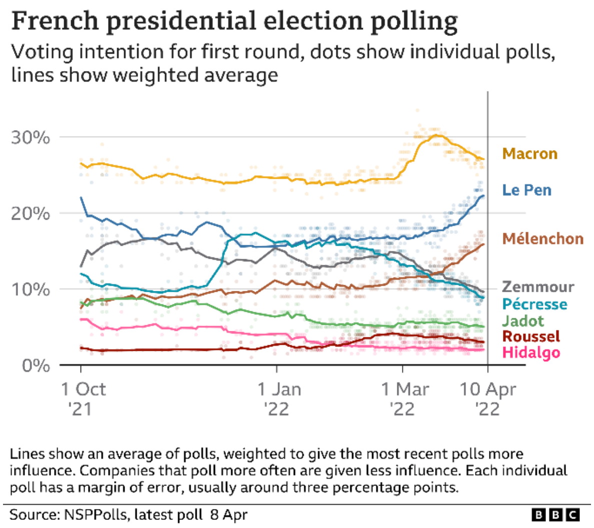
Le Pen's propositions during her election campaign include limiting free movement within the EU – to EU passport holders rather than EU residents – withdrawing from some of the EU's trade and energy agreements, and perhaps most unthinkably: forming strategic partnerships with Russia for European security. A Le Pen presidency would inevitably have resulted in a more fragmented EU, and potentially even create serious political conflicts within the bloc. Her stance on certain touchy issues had alienated some voters, allowing Macron to come through as the lesser of two evils.

This victory is not to say that Macron's worries are over – in fact, it may just be the start of a turbulent term in office. As the June legislative elections approach, France's left-wing parties have joined forces in a historic move to take Macron on for a majority in the national assembly, in hopes of creating a "cohabitation" (power sharing) scenario. In support of this move, one opinion poll suggests that 63% of voters want him to lose his majority in parliament as well. Such an arrangement would severely curtail Macron's ability to smoothly roll out his domestic agenda (resulting in a tighter than expected fiscal stance) and introduce proposed reforms e.g. pension reforms. This could potentially also compromise foreign policy interests for the country as well as for the region – France has a permanent seat in the UN Security Council, and is president of the EU till end-June 2022.

Tiens bon, ce sera bientôt fini!

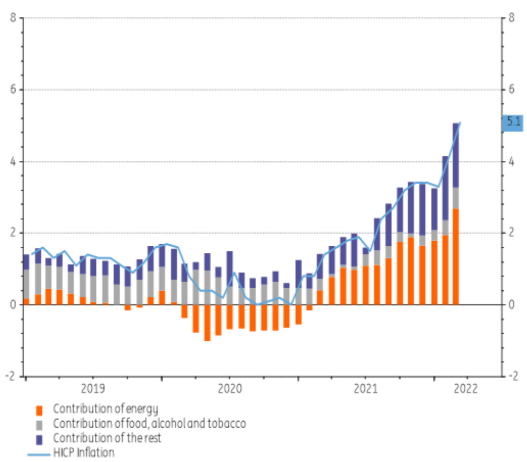
Consumer prices also climbed more rapidly, from a 4.5% YoY gain in March to 4.8% in April, with the main culprits being rising energy and food prices. Nonetheless, inflationary pressures have remained relatively subdued as compared to its peers in the Euro area. This was in no small part helped by measures implemented by the French government, such as "price shields" being imposed on gas and electricity prices (*bouclier tarifaire*) – which limited household electricity bill hikes to 4% this year. Markets, however, believe that inflation has yet to peak and will continue to surge to

Figure 26: France presidential election polling



Source: BBC News, NSPPolls

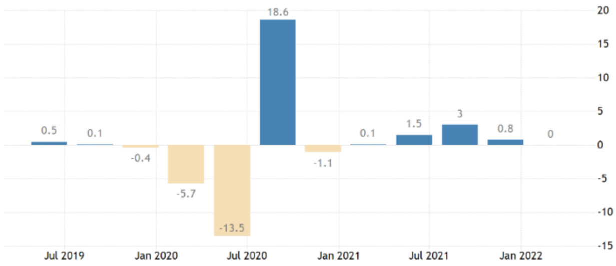
Figure 27: France inflation breakdown



Source: Refinitiv Datastream, ING Research new highs (5.4% in June) before possibly coming down over the second half of 2022.

The traditional driver of the French economy, household consumption (52.4% of 2021 GDP), shrank in Q1'22 amid surging energy costs and worsening supply chains (-1.3% vs 0.6% in Q4 2021), eclipsing any boost from the easing of COVID restrictions. Traditionally a services sector dominant economy (71.2% of 2020 GDP), economic growth in France will remain weak for as long as consumer spending is declining along with real household incomes. And the numbers speak for themselves: GDP showed no growth in the first quarter of this year from the year prior (Fig. 28), versus market expectations of a 0.3% growth. This downward trend for the second consecutive quarter (having already fallen from 3% in Q3'21 to 0.8% in Q4'21) justifies increasing market chatter about the dreaded 's' word – stagflation. While potential fiscal initiatives from Macron – such as the continuation of tax cuts, the proposed tripling of the exceptional purchasing power bonus, and electricity price caps etc – might indeed protect France from a huge contraction in economic activity, its effectiveness (or even realisation) eventually remains dependent on how the aforementioned legislative elections eventually pan out in June. Fasten your seatbelts, the ride is not over!

Figure 28: France Year on Year GDP growth



Source: Trading Economics, INSEE, France

Italy

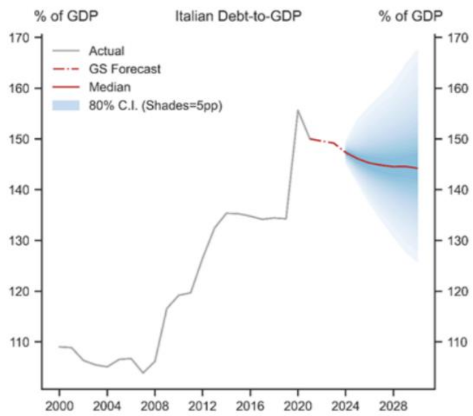
Increasingly wider spreads invoke memories of early 2010s

A hawkish shift by the ECB in line with rising rates in the rest of the world does not bode well for peripheral bond issuers like Italy and Spain that are more fiscally vulnerable, as tighter financial conditions and therefore weaker credit growth will almost certainly drag down Italy's ability to maintain high levels of public debt to revitalise its economy (Fig. 29). Italy is already the second largest debt market in Europe, right next to Greece (which is not good company!). Adding on to that widening fiscal deficit is the aforementioned (and possibly structural) increase in defence spending to meet their NATO commitments, following the emphasis on national security as highlighted by the events in recent months.

In the shorter term though, a faster ECB hiking cycle is not likely to have a material upward impact on debt financing costs. But rather, a "higher for longer" rates environment on top of widening BTP-Bund spreads may eventually lead to an unsustainable level of debt, particularly if Italy's potential growth level falls below expectations. Overall nominal growth will most likely take a hit, despite the resurgence in services activity after the unwind of Covid restrictions earlier in the year. Manufacturing sectors, especially those that are most reliant on energy supply from Russia, will see production cuts due to the disruption of oil and gas flows – and we also think we haven't seen the worst of it yet.

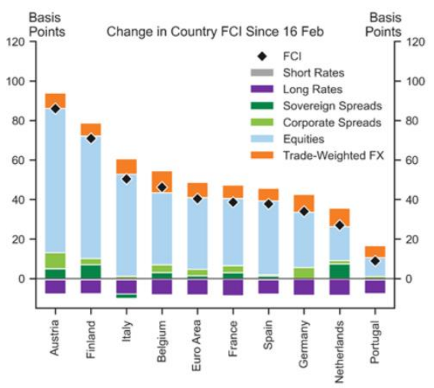
Previously, we thought the investment opportunities provided by the NGEU recovery fund's rollout combined with Italy's own domestic fiscal measures (National Recovery and Resilience Plan ~€170b since start of pandemic) would indeed be a turning point

Figure 29: Italy Debt-to-GDP ratio and projections



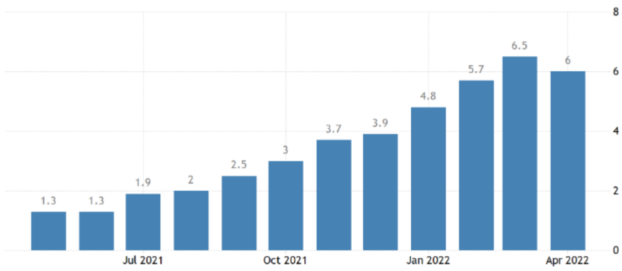
Source: Goldman Sachs Global Investment Research, Haver Analytics

Figure 30: Tighter financial conditions across the euro area



Source: Goldman Sachs Global Investment Research

Figure 31: Italy Inflation Rate



Source: Trading Economics

for the stale economic performance in the past decade. However, with recent developments it seems as though growth momentum will be much softer than expected, somewhat negating the effects of fiscal support in the short term. We will have to wait a while to see a regime change, perhaps in the second half of the decade.

On prices, fiscal support for households remains in place to ease the burden of the energy crunch on falling real incomes. The reduction in system charges and taxes on natural gas and electricity have been slated to remain in place, at least until the end of this quarter. This is a welcome relief for a country that has seen its inflation rate blow past a 30-year high of 6.5% in March (Fig. 31), before easing slightly last month on slower growth in energy costs.

A second term for Sergio and Mario

After eight rounds of voting, the theme of stability reigned supreme in a similar way to how France's own presidential elections panned out. Incumbent president Sergio Mattarella was formally re-elected after he agreed to stay on a second term, with Prime Minister Mario Draghi reportedly playing an instrumental role in convincing him to reconsider his earlier decision to leave office. No clear alternative candidate amongst Italy's governing coalition had emerged with a majority of the votes. This was also somewhat expected, given that no one with the right credentials had seized the opportunity to fill this seat (we had highlighted this in last semester's report, and no clear frontrunners emerged between then and now).

As an elected "compromise candidate", Mattarella's extended stay in power reduces a potential source of market volatility in an already uncertain economic climate – but this also shows an embarrassing lack of political mobility and unity within Italy's leadership, unable to gather together to shift away from the status quo. The tangible consequences of this election outcome are also relatively few and far between, as it has historically been a ceremonial role whose key capabilities are only needed in times of political crisis – such as the period after former Prime Minister Giuseppe Conte resigned over his mishandling of the pandemic. Italian sources also explain that this is also one of the very reasons "Super Mario" would never have taken up the presidency. Rather, the fault lines within the government that were revealed (or even deepened) by these proceedings means that the situation remains very fluid in Italy at least for the next few months.

Spain

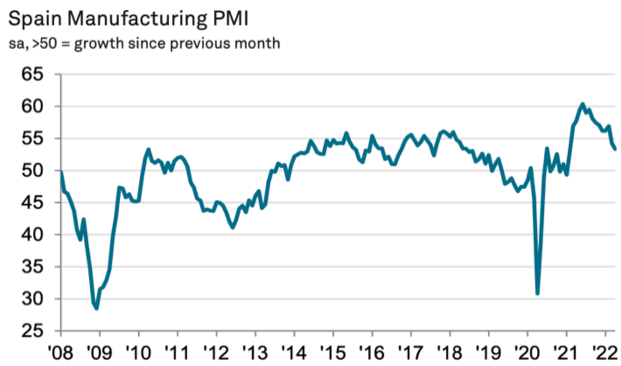
Siesta Foreva'

Out of the 4 largest economies in the Eurozone, the Spanish economy has experienced the weakest recovery. Q1 2022 GDP growth was lacklustre at 0.3%, slowing from the 2.2% it posted in Q4 2021. The Spanish economy remains 3.4% smaller than pre-pandemic. In early April, the Bank of Spain cut its forecasts for economic growth in Spain to 4.5% in 2022 and 2.0% in 2023. Inflation projections, on the other hand, were revised upward to

Figure 32: Unemployment Rate in Spain

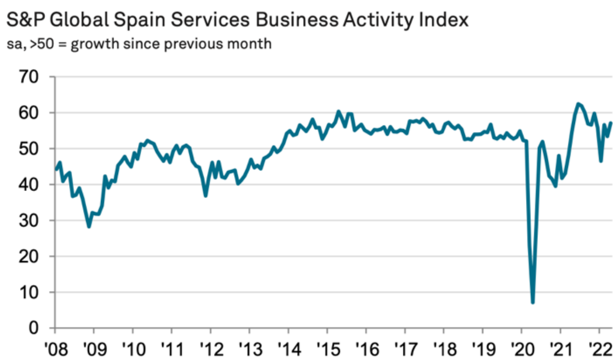
Source: Board of Governors of the Federal Reserve System

Figure 33: Spanish Manufacturing PMI



Source: S&P Global

Figure 34: Spanish Services PMI



Source: S&P Global

7.5% in 2022 and 2.0% in 2023, up from previous estimates of 3.7% and 1.2% respectively. The Spanish unemployment rate rose slightly to 13.65% in Q1 2022, with the economic recovery appearing to have stalled (Fig. 32). Spanish Manufacturing PMI continued its fall to 53.3 after peaking in 1H 2021 (Fig. 33). Underlying data was even weaker, with new orders falling for 2 successive months since March. Similar to Germany, however, the Spanish services sector continues a strong recovery, with the Services PMI jumping from 53.4 in March to 57.1 in April (Fig. 34). Looser Covid-19 restrictions have led to an increase in higher market demand driven primarily by domestic clients.

In early March, transport workers begun sporadic strikes in response to the high inflation, especially in energy. In response, Prime Minister Pedro Sanchez's Spanish government approved a 3-month long, €16 billion plan, to cushion the blow of the Ukrainian crisis on the Spanish economy. The Spanish government will spend €1.4 billion to reduce fuel costs by €0.20 a litre, and provide €500 million in subsidies to energy-intensive industries. The Spanish government also undertook to provide €10 billion in state loans to help firms facing liquidity issues as a result of the spike in energy prices. It also adopted broader measures to combat inflation, including limiting rent increases to 2.0% until the end of June.

Figure 35: EUR/BRL Weekly Chart

Source: Trading View

Figure 36: EUR/BRL Daily Chart

Source: Trading View

Trade Idea: Long EUR/BRL

We hold a rather bullish view of the Euro in the short to medium term that is mainly based around the rate hikes poised to come in 2H'22. This is in spite of long-term growth concerns in Europe, which have picked up noticeably since the war that exacerbated the effects of the energy crunch. Minutes from the ECB's April meeting released recently have reaffirmed our stance that hikes are coming, and it is now a question of how much they will be hiking as soon as at the July meeting.

Further to add, since the services sector makes up a large chunk of the eurozone economy (~75%), the slowdown in manufacturing that translates to a widening trade deficit is likely to weigh less on the Euro than anticipated by markets.

Instead, we prefer to express our view of slowing global growth through the high beta Brazilian Real. China historically consumes more than 30% of Brazil's exports (31.7% in 2020), and with the stickiness of the zero-Covid policy amidst an elongated period of regulatory clampdowns, these predominant factors are likely to weigh heavily on Chinese and, consequently, Brazilian growth.

Moreover, Brazil is well into its tightening cycle, being one of the first ones out of the gate to raise its benchmark interest rate (the Selic) post-Covid along with most other emerging market economies. Accordingly, although the central bank recently shifted away from previous communication detailing an end to the tightening cycle in June, we expect that this said end will still fall right around the time when the ECB can be expected to make its first move. Policy rate divergence will then become one of the key drivers of this expected move up in the pair.

The downside to the trade would materialise if firstly, price pressures remain elevated for longer across the world, thus causing Brazil to exercise caution and tighten policy even further to tame inflation (which is their current focus rather than growth). Secondly, we also run the risk of an escalation in geopolitical tensions, as if Sweden and Finland's applications to join NATO are successful, this could be a significant development in the war. If Putin and his allies (Turkey) choose to retaliate against these countries, this would drag the world into a doomsday scenario of WWIII with NATO forced to send boots on the ground. This is a tail risk that has astronomical consequences, and the probability of it materialising is not insignificant.

<u>Technical Analysis</u>

The pair has been on a consistent downtrend since the start of the year, but is not in oversold territory yet based on the Relative Strength Indicator. It is worth continuing to monitor if the recent break higher towards the 5.45 handle in early May was indeed a trend reversal, or whether it was a fake move with little support and we will be seeing more Real strength in the near term.

We set our target price roughly around the 78.6% Fibonacci retracement level, and we see this as a medium-term trade of around 6-9 months.

<u>Trade</u>

Long EUR/BRL

Entry: 5.1357
Take Profit: 6.6813
Stop Loss: 4.7635
Risk Reward Ratio: 4.15

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Global Macro Department – Switzerland (NEUTRAL)

Date: 19th May 2022

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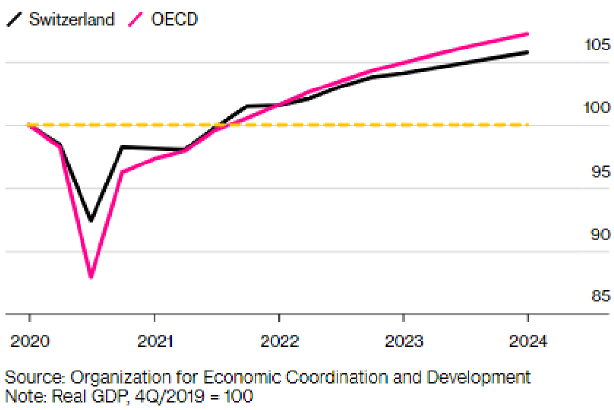
Basic Information

Real GDP (CHF Billion)	187.5 (2021)
M2 (CHF Billion)	1,096 (Mar-22)
CPI	103 (Apr-22)
PPI	108 (Apr-22)
Con. Confidence	-18.5 (Q2'22)
Currency	Swiss Franc (CHF)

Source: Trading Economics

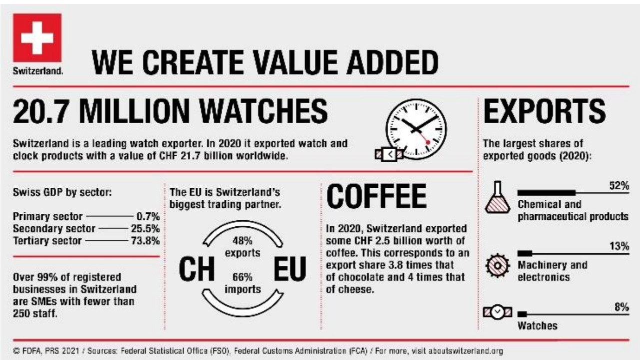
Chart info

Figure 1: Real GDP (2019 base = 100)



Source: OECD, Bloomberg

Figure 2: Swiss economic details



Source: Presence Switzerland PRS

Overview of Switzerland

- Switzerland has been one of the world's wealthiest nations for the past century, with the latest IMF estimates now having Switzerland in 20th place globally by size of nominal GDP, although it fell to 4th place by nominal GDP per capita behind Luxembourg, Ireland, and Norway.

- It is also known for its neutrality (aside from condemning the Russian invasion) and notorious banking secrecy laws, which have helped ensure external security and promote peace, while also allowing its banking sector (headlined by storied private banks Credit Suisse, UBS, and Julius Baer) to flourish.

- Admirably, Switzerland also ranks highly in economic ranking indexes despite having a small population of 8.8 million people (as of 2022), coming in first in both the 2021 Global Innovation Index and the 2021 World Competitiveness Ranking.

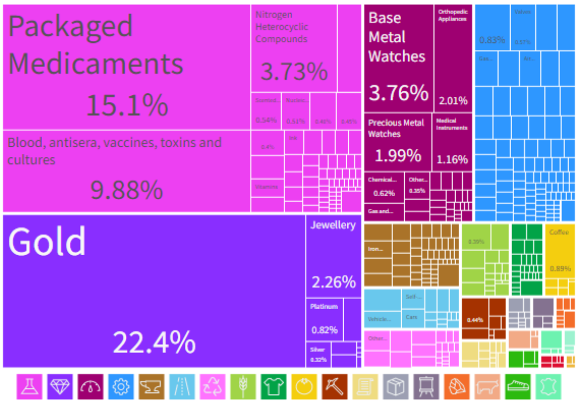
- This historically efficient and robust economy coupled with good governance (as seen in its strong response to the pandemic) has resulted in the Swiss brand taking the title of the world's strongest nation brand from Germany in 2021, according to Brand Finance Nation Brands ranking. Switzerland's economy is primarily built around its service industry (73.8%), dominated by the financial services and tourism sectors. Other major industries include industry (25.5%) and agriculture (0.7%), and over 99% of Swiss businesses are SMEs (less than 250 staff). Switzerland also is a relatively open market, with a trade-to-GDP ratio of 116% (2020).

- The European Union (EU), with its close geographical proximity, is understandably Switzerland's largest trading partner, producing approximately 66% of Swiss imports and receiving 48% of Swiss exports (Fig. 2). By agreeing to certain provisions of the European Common Law, Switzerland is able to maintain access to the common European market, facilitating smooth trade flow.

- Switzerland also has diverse trade relationships outside of Europe, with U.S., China and the UK being the EU's 2nd, 3rd and 4th largest trading partners respectively. Switzerland mainly exports gold ($68.5b), packaged medicaments ($26.6b), antisera ($11.8b), base metal watches ($11.5b) and nitrogen heterocyclic compounds ($11.4b) to these countries (Fig. 3).

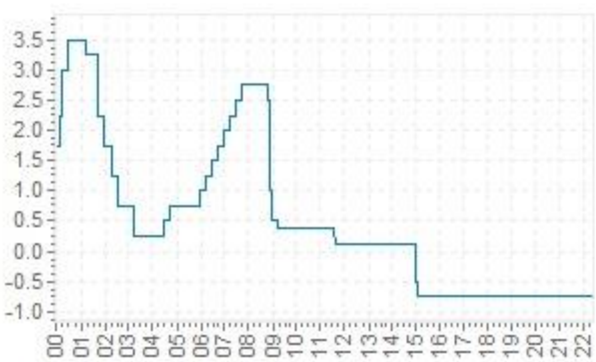
- Its currency, the Swiss franc (CHF), is widely considered a safe haven currency due to Switzerland's stability and political neutrality. With this reputation, stability, and good governance, investor confidence in the Swiss franc is

Figure 3: Swiss Exports by Product



Source: Observatory of Economic Complexity (OEC)

Figure 4: SNB Policy Rate



Source: Global Rates

high, causing it to often be used as a hedge against market volatility – particularly in recent times where it reached levels last seen in 2015.

- Interestingly, the city of Lugano in Switzerland announced in March that it would accept Bitcoin as legal tender and allow citizens to pay for public service fees and taxes in Bitcoin. In a bid to attract blockchain businesses and enthusiasts to relocate to the city, which is also the host of the Bitcoin World Forum, Lugano's city director Pietro Poretti wants to create a business-friendly environment featuring minimised bureaucracy and ideal conditions for businesses in these fields to thrive.

Summary of Events in the Past 6 Months

Fiscal Policy

- Fiscal policy in Switzerland has always been relatively conservative. The Swiss have a "debt brake" rule, in which over the medium term (an economic cycle), the federal budget must be balanced. Budget surpluses generated during economic expansion must be sufficient to pay off the deficits during economic contraction. This has been instrumental in keeping public debt to only 42.7% of GDP, compared to its highly leveraged European peers.

- In line with this rule, the government did not go overboard like most other countries in response to the pandemic, but distributed aid in a deliberate and conscientious manner – primarily to sectors that were worst hit, including the tourism, hospitality, and personal services sectors. As a result, Switzerland's budget deficit was -2.2% in 2020 and 2% in 2021, compared to a deficit of -12.4% in the US for 2021.

- To bring the fiscal position of Switzerland back in line with its debt brake rule, the government aims to run an annual budget surplus of CHF2.3 billion from 2023.

- The Swiss Federal Council also announced the implementation of the 15% global minimum tax as agreed by the OECD Inclusive Framework through a constitutional amendment, with a target completion date in 2024.

Monetary Policy

- The Swiss National Bank (SNB) conducts an in-depth monetary policy assessment at the end of every calendar quarter, where it makes its monetary policy decision and publishes its medium-term inflation forecast.

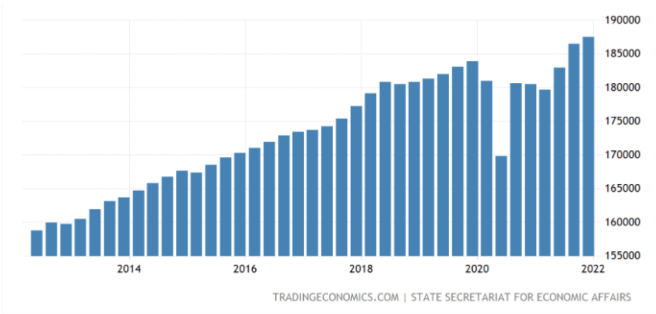
- The SNB interest rate has been set at -0.75% since January 2015 (Fig. 4). However, the recent bout of inflation has finally and imminent ECB policy normalisation has led the market to start pricing in SNB hikes. Indeed, there has been a material change of tone from the SNB in recent communications, where inflation risks to the upside were noted and Chairman Thomas Jordan stressing "the SNB is ready to act if inflation risks materialise".

- During the March 2022 meeting, the SNB maintained the interest rate at -0.75%, and mentioned that they were willing to “intervene in the foreign exchange market as necessary, in order to counter upward pressure on the Swiss franc”. Driven by supply bottlenecks and energy inflation stemming from the Ukrainian crisis, the inflation forecast for 2022 rose to 2.1%, and 2023 and 2024 estimates were revised upward to 0.9%.
- During early April, there was a noticeable increase in the amount of SNB sight deposits – indicating SNB intervention to mitigate CHF appreciation. Yet, Jordan noted that had the CHF not appreciated, the monetary policy stance of the SNB would have become even more expansionary, and “given the current development of inflation, that would not have been appropriate.” This was an acknowledgement that the appreciation of the CHF has helped to contain inflationary pressures in Switzerland.

Geopolitical Events

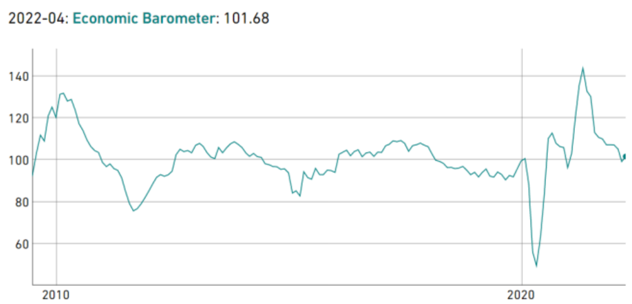
- In response to the Russian invasion, Switzerland broke its longstanding tradition of political neutrality, adopting and enforcing European Union sanctions on Russia. The latest move includes a ban on Russian coal imports. Switzerland also blocked the equivalent of $8b in Russian assets belonging to wealthy individuals and oligarchs, as of early April. However, Swiss Finance Minister Ueli Maurer has said that he does not expect much negative impact on the Swiss financial system, given that Russia wealth makes up for only 1% of annual Foreign Direct Investment (FDI) into Switzerland.

Figure 5: Real GDP level (in millions of CHF)



Source: Trading Economics

Figure 6: The KOF Economic Barometer



Source: KOF Swiss Economic Institute

Figure 7: Swiss Growth Forecasts (March)

Economic forecasts Switzerland
Growth rates in % unless otherwise stated, growth contributions in percentage points,
GDP and components: volumes, seasonally adjusted; foreign trade: excluding valuables

	2020	2021	2022 *		2023 *	
GDP and components						
GDP, sport event adjusted	-2.6	3.6	**2.8**	(3.0)	**2.0**	(2.0)
GDP	-2.5	3.7	**3.0**	(3.2)	**1.7**	(1.7)
Private consumption	-3.7	2.7	**3.6**	(3.8)	**1.9**	(2.0)
Government consumption	3.5	2.7	**-0.7**	(-1.5)	**-1.4**	(-1.9)
Investment in construction	-0.4	1.2	**-0.5**	(0.0)	**0.2**	(0.2)
Investment in fixed assets and software	-2.5	4.0	**3.4**	(4.0)	**3.4**	(4.0)
Exports of goods	-1.7	11.5	**4.2**	(3.8)	**3.7**	(4.1)
Exports of services	-14.6	10.4	**8.5**	(10.0)	**5.0**	(5.6)
Imports of goods	-6.3	4.7	**4.7**	(4.3)	**3.9**	(5.0)
Imports of services	-10.5	6.5	**8.0**	(8.4)	**5.5**	(5.5)
Contributions to GDP-growth						
Final domestic demand	-2.0	2.4	**2.2**	(2.4)	**1.4**	(1.5)
Foreign trade	0.1	3.6	**0.6**	(0.7)	**0.4**	(0.4)
Labor market and prices						
Employment in full-time equivalents	0.1	0.6	**1.8**	(1.5)	**0.9**	(0.9)
Unemployment rate in %	3.1	3.0	**2.1**	(2.4)	**2.0**	(2.3)
Consumer price index	-0.7	0.6	**1.9**	(1.1)	**0.7**	(0.7)

* Forecasts by the Federal Expert Group on Business Cycles from 14.03.2022, forecasts from 09.12.2021 in brackets.
Sources: FSO, SECO

Source: SECO

The Road to Recovery

Things were going well, until…

…the pandemic took a toll on the Swiss economy in 4Q'21, as health restrictions amidst the arrival of the Omicron variant put a dent in what was otherwise a respectable growth rate in the first three quarters of the year for the wealthy nation. Real GDP levels recovered past its pre-Covid levels (by 2%), leaving Europe in the dust.

Although traditionally a services-oriented economy with more than 73% of its GDP coming from service sectors, it was Swiss manufacturing that performed extraordinarily well with activity increasing by 11.2% in 2021 after a 3% decline in 2020, driving GDP outperformance. The chemical and pharmaceutical sector in particular, which accounts for more than 43% of Swiss manufacturing output and is Switzerland's leading exporter, has been relatively insulated from the widely talked-about supply chain bottlenecks due to the availability of onshore production infrastructure. Production in this sector was 20% higher than its pre-crisis level (end-2019), while the remaining industrial production sectors came in 4.4% higher. Furthermore, it has also benefited from the structural increase in demand for healthcare and pharmaceutical products amidst the pandemic and an ageing global population. Demand for Swiss watches, one of the key Swiss exports, was particularly strong from China and the United States. This resurgence in 2021 follows its worst year in history in 2020.

The jobs market has also been exceptionally resilient and therefore creating a tight labour environment for businesses, as they have been reporting difficulty in finding skilled workers across most industries. This coincides with the low levels of unemployment we are currently seeing (2.3% in April, the lowest reading since 2019). Increased employment and stable incomes have also led to growth in consumer spending, which has therefore supported GDP growth, brushing off several bouts of movement restrictions throughout the year to clock in at 0.9% above end-2019 levels.

Switzerland's KOF economic barometer (Fig. 6), published by the KOF Swiss Economic Institute, typically provides us with a good sensing of where the economy will be headed in the near term. The gauge had been falling for many periods before rising to 101.7 in April this year, beating market expectations of 99.4 and returning above the long-term average of 100. This is in line with our expectations that the outlook for Switzerland is rather favourable in the short term, not least due to an anticipated recovery in demand for services activities with the complete easing of border restrictions. These measures are set to revitalise the Swiss tourism industry, which contributed as much as 8.7% to the Swiss GDP prior to the pandemic.

Risks to this outlook are skewed to the downside however, due to both softer foreign demand and domestic consumption. This is in line with forecasts by the Switzerland State Secretariat for Economic Affairs (SECO), which was adjusted downwards from its last published report in December 2021 (Fig. 7). Global growth momentum appears to be headed downwards with the stickiness of China's zero-Covid policy and the volatility induced by geopolitical tensions. These have forced the realignment of alliances between countries at the macro level, and reshoring of production/ supply chains at the company level with business executives repositioning themselves to better protect shareholder interests.

Inflation in... wait for it... Switzerland?!

Last year, we called for an unchanged monetary policy environment at least till 2024, based off relatively benign inflationary forecasts. However, the worrying growth in price pressures has caused inflation figures to even surpass the target of one of the most disinflationary economies. Price stability in perspective of the Swiss National Bank (SNB) is determined as an inflation rate below 2%. CPI growth in Switzerland cracked 2.5% in April, its highest figure on record since the 2008 financial crisis (Fig. 8). In the decade since then, Switzerland has shifted between disinflationary regimes (i.e. a negative annual inflation rate) and deflationary environments (i.e. a fall in annual inflation rate that is still positive). This is also considered by the SNB to be contrary to their price stability objective.

Figure 8: Switzerland Annual Inflation (since 2005)

Source: Trading Economics

Figure 9: Switzerland Inflation Breakdown

General price development in Switzerland (change in %)

	2016	2017	2018	2019	2020	2021
Consumer Prices	-0.4	0.5	0.9	0.4	-0.7	0.6
Producer and Import Prices *	-1.8	0.9	2.4	-1.4	-3.0	2.7
Construction Prices	-0.5	-0.6	0.5	0.6	0.1	2.6

* = Price index of total supply

FSO, Swiss Consumer Price Index,
FSO, Producer and Import Price Index
FSO, Swiss construction output price index

Source: Federal Statistical Office, Switzerland

However, in relative terms compared to the rest of the world, price growth is considered relatively subdued. This was helped by a strong Franc (which will be discussed in the monetary policy section below) as well as a favourable mix of energy sources. Most of its crude oil is imported from Africa (~50%), Mexico (18%), and the U.S. (12%), while electricity power is mainly generated by hydropower (~60%) and nuclear power (33.5%). Energy as a result takes up only 5% of the Swiss CPI basket, and it is healthcare expenditures that actually account for 17% of the index instead. On this front, the government has helped alleviate the cost burden on consumers by encouraging insurers to lower premiums. Furthermore, rents in Switzerland are also not indexed to go up along with inflation. All these factors taken together leave consumer price growth relatively subdued versus producer prices (Fig. 9), which have unsurprisingly ticked upwards due to the recent surge in commodity (oil in particular) and raw material prices. Therefore in March, the SNB upgraded their projections to a 2.1% inflation rate in 2022, before falling to a similarly-upward revised 0.9% in 2023 and 2024.

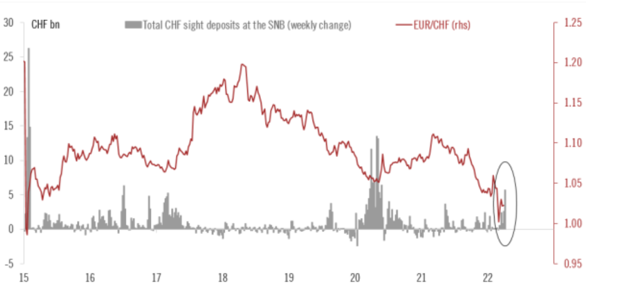
SNB: Hiking up the Alps?

The SNB has the objective of price stability, defined as an annual inflation rate below 2%. Deflation (i.e. a fall in annual inflation rate) is considered by the SNB to be contrary to their price stability objective. Since it abandoned the EUR/CHF FX floor of 1.20 in 2015, the SNB has relied on its interest rate and FX interventions to ensure that the goal of price stability is achieved. The SNB interest rate has been set at -0.75% since

Figure 10: Switzerland 2Y Government Bond Yield

Source: TradingView

Figure 11: Increase in CHF sight deposits at the SNB



Source: Bloomberg

January 2015. However, the recent bout of inflation and the imminent ECB policy normalisation has led the market to finally start pricing in SNB hikes. Indeed, there has been a material change of tone from the SNB in recent communications, where inflation risks to the upside were noted and Chairman Thomas Jordan stressing "the SNB is ready to act if inflation risks materialise". ING has even opined that it expects the SNB to hike 3 times by Q1'23, with the first hike in September 2022, to bring the policy rate back to 0%. This is largely in line with market pricing, with the 2Y Swiss Government Bond yield touching 0% during late April to early May (Fig. 10). The ECB policy normalisation provides a rare opportunity for the SNB to normalise its policy without causing excessive CHF demand, which may disrupt Swiss trade and demand.

Although the SNB has stressed that it was willing to allow the CHF to appreciate to a certain extent, the strong CHF inflows following the Ukrainian crisis caused EUR/CHF to reach parity briefly in March. Correspondingly, the SNB has intervened moderately in the FX markets this year due to safe haven flows triggered by the Ukrainian crisis, which threatened to derail the SNB from achieving its price stability objective. During early April, there was a noticeable increase in the amount of SNB sight deposits – indicating SNB intervention to mitigate CHF appreciation (Fig. 11). Yet, Jordan noted that had the CHF not appreciated, the monetary policy stance of the SNB would have become even more expansionary, and "given the current development of inflation, that would not have been appropriate." This acknowledgement, that the appreciation of the CHF has helped to contain inflationary pressures in Switzerland, was a notable deviation from their usual interventions against CHF strength over the past decade.

In late April, Jordan explained the SNB's decisions not to raise rates in March. Firstly, inflationary pressures in Switzerland were elevated, but moderate. Secondly, the SNB viewed that inflation is likely to decline to within the 0% - 2% target range of the SNB. The SNB has not seen a broadening of inflation within the Swiss economy, with inflation limited to commodity prices. As such, they maintain their projections that inflation in Switzerland will be at 2.1% in 2022, before dropping again in 2023 and 2024. However, he asserted again that should price pressures accelerate or broaden, a change in policy stance is on the table.

Since peaking around 1.11 in March 2021, the EUR/CHF FX rate, which is closely monitored by the SNB, has declined to approximately 1.03 – 1.04 in Q4 2021. This decline can be attributed to a decline in the value of the Euro as Eurozone yields fell as a result of ECB QE programs as well as a less optimistic global growth outlook. The continued decline in global growth outlook and risk-off flows have led to another leg of CHF strength, with EUR/CHF going under 1.03 and even flirting with parity. Going forward, changes in the EUR/CHF FX rate will be heavily affected by the policy decisions of the ECB and SNB. We think that downside risks are contained because the SNB will not get ahead of the ECB in the policy

Figure 12: EURCHF Daily Chart

Source: Trading View

Figure 13: EURCHF Weekly Chart

Source: Trading View

Figure 14: EURCHF Monthly Chart

Source: Trading View

normalisation path. Tactical longs in EUR/CHF may be well advised.

Trade Idea: Long EURCHF

As the ECB normalises policy, upward pressure on yields will occur through 2 main channels. First, directly through an increase in the policy rate. Secondly, indirectly through a decrease and eventual end in EGB purchases that will lead to an increase in net EGB supply. The SNB does not set policy independent of external conditions, and is likely to tighten if and only if the ECB does so. As such, we think that there is an in-built divergence in the rate of tightening of policy as a result of the SNB's reaction function.

Furthermore, while the SNB may in theory welcome a modest appreciation of the CHF to counter imported inflation, its demonstrated interventions in the FX market to counter CHF strength suggests that excessive CHF appreciation remains contrary to the SNB's goal of price stability. This is especially so with the SNB's inflation forecasts for 2023 and 2024 firmly within the target range, implying that the SNB is well on-track to achieve its goal of price stability and that there are no signs of unanchored inflation expectations, unlike in the Eurozone, where inflation swaps hint that inflation expectations have begun to reprice upwards. The latest SNB policy guidance in March is still to prevent excessive appreciation of the Franc, which, through trade channels, dampens Swiss economic growth and lowers the general price level, preventing the SNB from achieving its objective of price stability.

As such, we recommend buying EUR/CHF on dips towards 1.00.

Technical Analysis

On the daily chart (Fig. 12), EUR/CHF briefly breached parity in early March, but recovered strongly. This is highly encouraging and suggests that the 1.00 level is being defended by bulls (or the SNB). On the weekly chart, EUR/CHF price action is not yet indicative of a bottom (Fig. 13). It is likely that more consolidation and sideways movement is necessary for a firm bottom to be in. We recommend that traders scale into a long position and take profit at the September 2021 high of 1.09.

Trade

Long EUR/CHF

Entry: 1.00
Take Profit: 1.09
Stop Loss: 0.9650
Risk Reward Ratio: ~2.69

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Global Macro Department – United Kingdom (UNDERWEIGHT)

Date: 19th May 2022

Analyst

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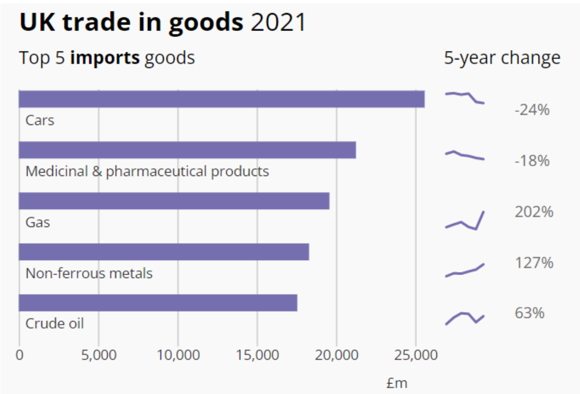
Basic Information

Real GDP (GBP Trillion)	2.20 (2021)
M2 (GBP Trillion)	3.03 (Mar-22)
Current Account (GBP Million)	-7.30 (Mar-22)
Core Inflation Rate	6.20% (Apr-22)
CPI (based on 2015)	120.0 (Apr-22)
PPI (based on 2015)	126.7 (Apr-22)
Con. Confidence	-30 (May-22)
Unemployment rate	3.7 (Mar-22)
Currency	GBP

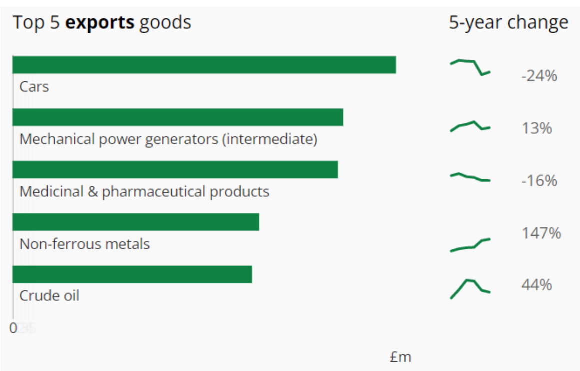
Chart info

Figure 1: Top 5 Imports Goods



Source: Office for National Statistics

Figure 2: Top 5 Exports Goods



Source: Office for National Statistics

Overview of United Kingdom

The United Kingdom comprises England, Scotland, Wales, and Northern Ireland, and uses the pound sterling as its national currency. It is the fifth-largest national economy in the world with a GDP of 2.2 trillion British pounds in 2021. The economy is mainly driven by the services sector, which constitutes 72.8% of its GDP. The industry and agricultural sectors make up 16.9% and 0.6% of the GDP respectively.

Trade plays a pivotal role in the UK economy, contributing 1.07 trillion USD and 48.6% of its GDP in 2021. Exports and imports each contributed 18.6% and 30.0% to its GDP. Top imported goods include cars, medicinal & pharmaceutical products, gas, non-ferrous metals, and crude oil, while the top exports comprised cars, intermediate mechanical power generators, medicinal & pharmaceutical products, non-ferrous metals, and crude oil.

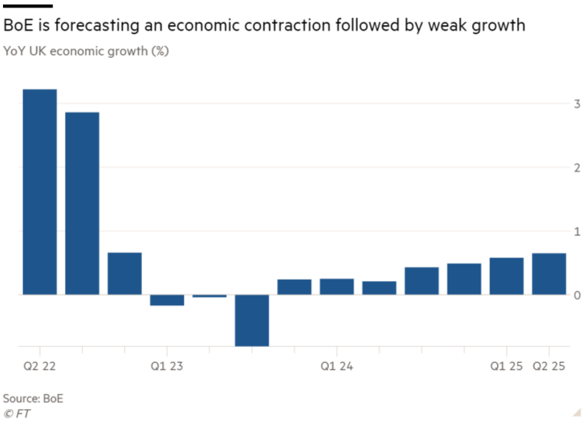
Despite its withdrawal from the European Union single market, the EU remains its largest commercial partner, with transactions accounting for 49.0% of the country's exports and 52.0% of its imports in 2020. However, post-Brexit Britain has seen its exports to the bloc fall by £20 billion in 2021, reemphasising the disproportionate impact of leaving the union.

Summary of events in the past 6 months

- BoE raised interest rate by 25 bp to 0.5% to quell inflationary pressures in February
- The UK sanctioned 5 Russian banks in response to Russia's incursion into Ukraine
- The UK and its allies removed Russian banks from the SWIFT payment network, and froze foreign reserves on the Central Bank of Russia
- British Petroleum announced its withdrawal from its 19.75% stake in Rosneft, the Russian state-owned oil company
- The UK introduced further sanctions on Russian vodka, metals, fertilisers, luxury goods, and other commodities
- BoE further hiked rates by 25 bp to 0.75% in March
- Ofgem lifted Britain's energy price cap by 54.0% from £1,277 to £1,971
- BoE hiked for the fourth consecutive time in April by 25bp to 1.0%, its highest ever since Feb 2009 with warnings of inflation soaring to 10.0% in 2022
- Unemployment fell to unprecedented levels since 1974, with job vacancies far outweighing the number of unemployed people for the first time on record
- The government unveils a plan to unilaterally push forward without parts of the Northern Ireland protocol in post-Brexit trade activities

Economic Growth

Figure 3: Forecast of An Economic Contraction



Source: Bank of England

In the first quarter, Britain saw its real GDP rise by 0.8%, one of the highest among its Western European counterparts. However, this growth was largely due to the January rebound as Covid restrictions eased. There was no growth in the subsequent two months, with BoE's latest statistics revealing a 0.1% contraction in the country's GDP in March. This was attributed to the services and manufacturing slowdown that offset the increase in construction. The loss of economic momentum in the two subsequent months underlines downcast growth prospects in the second quarter.

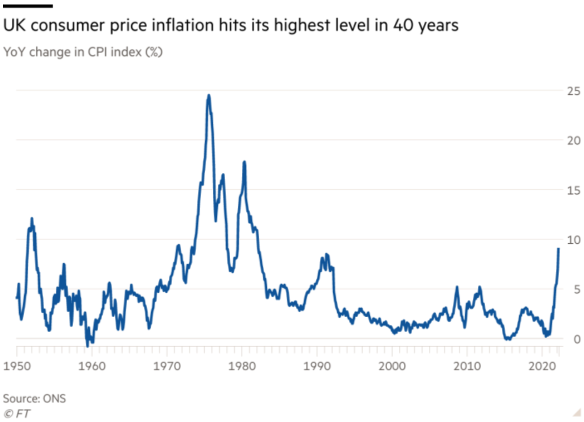
Further exacerbating the dismal outlook is the deteriorating economic conditions. As the Russia-Ukraine war intensifies, global energy costs have soared to record highs, putting additional strain on energy consumption. Accompanied by renewed supply-chain disruptions from China's lockdowns, near-term headline inflation can reach up to 40-year highs and remain elevated throughout the year. This would amplify the real-term squeeze on household incomes, slashing consumer confidence further. This, alongside domestic tax raises and higher interest rates, significantly increases the likelihood of a continued contraction in the second quarter.

Statistics from March have already flagged the decline in output under the services and industrial sectors. Wholesale and retail trade have witnessed a drastic decline for the fourth consecutive month, underscoring the noticeable slowdown in consumer spending. Businesses in the hospitality and entertainment sector experienced slight growth due to the shift of consumer spending on goods to services post-pandemic and the healthcare sector recorded a material rise in output. However, these were not enough to offset the decline in the other categories.

With the expectations of a downward revision of the 2022 growth forecast, the prospects of a technical recession are increasingly likely.

Soaring, Persistent Inflation

Figure 4: Sky Rocketing CPI



Source: Office for National Statistics

With an acute slowdown in economic activity in the first quarter of 2022, the UK economy is experiencing its worst bout of stagflation since the 1970s. The month of April saw inflation soar to 9.0% on a YoY basis, the highest in four decades, and the highest among the G7 countries and any advanced economy.

This rise is predominantly driven by the spike in energy prices, with three-quarters of it attributed to the 54.0% increase in the country's energy price cap that month. Prices also rose across almost every category of expenditure. Factory goods saw a dramatic rise in prices to the extent of 14.0% YoY in April, the highest since July 2008. The 18.6% spike in prices of raw materials also exerted further inflation pressure on manufacturers, who passed on their higher input costs to consumers. Prices of services were also up 4.7% YoY.

With utility bills due to rise in October again with the adjustment of the country's energy price cap, we expect to see yet another spike in inflation on the back of energy. Currently, the electricity and gas forwards underline another estimated hike of 35.0%. Another key risk in the UK's spiralling inflation is the embedment of the persistent inflation in wage negotiations as workers attempt to ease the squeeze on their real earnings, which will lead to wage push inflation.

With projections of inflation continuing to rise beyond 10.0% in autumn, far over BoE's 2.0% target, the Bank remains under pressure to raise interest rates further to cool the economy.

An Extremely Tight Labour Market

Beyond its contention with the soaring energy prices rippling through the global market, Britain is also grappling with a tight labour market characterised by widespread worker shortages fuelling wage pressures. This leaves it especially vulnerable to the combination of low economic growth with persistently high inflation, a stagflationary environment.

Wages are increasing at an unsustainable pace and companies are passing them on to customers. The May official jobs data revealed that the unemployment rate was near half-century lows of 3.7% in the first quarter. Job growths have also strengthened. Despite so, employment was still lower than pre-pandemic levels due to a large number of workers leaving the workforce. This has resulted in record-high numbers of 1.3 million vacancies, which are not just higher than pre-Covid levels, but also those consistent with pre-Covid trends, and earnings growth reaching 7.0% as companies compete for scarce employees.

Against this backdrop, the UK evidently faces a more pronounced risk of persistent inflation over a much longer period than its European counterparts. This corresponds to BoE governor Andrew Bailey's fears of a "labour market (that) does not cool down".

In response to May's statistics, the MPC underlined the importance of striking a balance between its growth rates and taming its soaring inflation. More importantly, there was a need for higher unemployment and a financial squeeze on households to quell inflationary pressures in the economy.

While current data strengthens the case for further interest rate hikes again next month, we should also weigh the possibility of people re-joining the workforce or working longer hours as households experience a deepening financial squeeze. Moreover, we can expect immigration to pick up as travel restrictions ease globally. Since the pandemic broke up, an estimated 1.3 million immigrants have left the UK. The gradual global reopening will likely increase the supply of workers in Britain's labour market, especially in the health and social work, and retail industries where foreign workers contribute 16.0% and 11.0% of its workforce respectively. Such scenarios can provide some respite to the tight labour market.

Bank Of England

In the first quarter of 2022, we saw a hawkish BoE raising rates at each of its last four meetings and announcing the unwinding of its balance sheet.

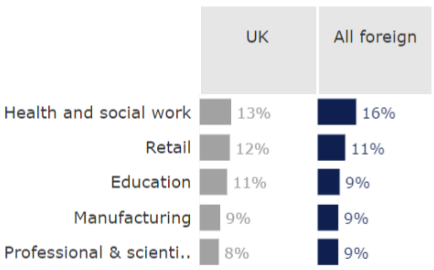
Figure 5: Unemployment rate

Source: Office for National Statistics

Figure 6: Record job vacancies

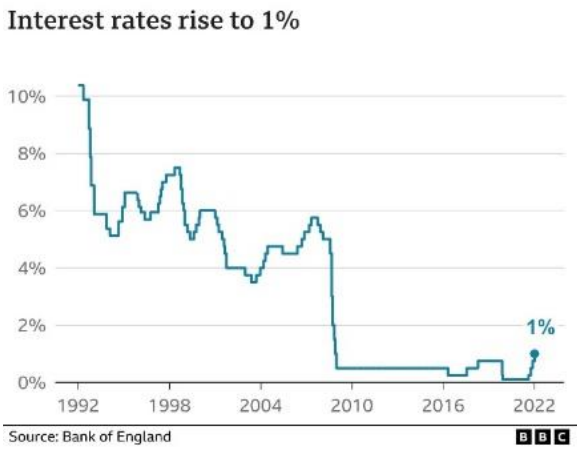
Source: Office for National Statistics

Figure 7: Top 5 industries with most foreign workers



Source: Migration Observatory, University of Oxford

Figure 8: BoE's Interest Rates



Source: Bank of England

Beyond the global shocks from the Russian-Ukrainian crisis and China's major city lockdowns, the tight labour market remains a key sector in influencing BoE's rates. If rapid wage growth persists, it will negatively feed further into consumer prices, exacerbating inflation and fuelling the incentive to hike further. This was strikingly evident in BoE chief Andrew Bailey's warning on 'apocalyptic' food prices as he reiterated his calls for workers to refrain from demanding pay raises to prevent a further descent into the wage-price spiral.

On 16 May, the BoE governor announced the bank's commitment to hiking rates adequately to ensure an inflation rate below its forecasted peak of over 10.0% and the return to its 2.0% target. This was raised after the country saw its CPI hit 7.0%, the highest in the last three decades in March. In May, we also witnessed the Monetary Policy Committee raising its main interest rate by 25 bp to 1.0%, signalling a hawkish BoE.

As recession risks loom over the economy, we expect to see a more cautious BoE as they balance between its fight against the UK's soaring inflation and the risks of a recession. Nonetheless, we can still expect more tightening in the near term.

Northern Ireland Protocol

Following Britain's demands last July for a reform of the post-Brexit trade deal in Northern Ireland, the North Ireland Protocol, both sides have negotiated over the course of the last six months but have failed to break the deadlock.

Summary of the central disagreements:

Movement of Goods

Currently, with the removal of a hard border on the island of Ireland, all goods transported from Great Britain to Northern Ireland should adhere to EU's single market regulations, inclusive of disruptive bureaucracy to maintain food standards.

However, the UK believes that divides its internal market and instead proposes a check-free green lane for goods en route to Northern Ireland, and a red land with full checks for those going to the Republic of Ireland.

In response, Brussels offered the easing of checks on food-related products by 80% and the reducing of paperwork by 50%. However, it rejected the UK's proposals to submit only industry-based data on products bound for Northern Ireland and the easing of controls over products from Great Britain to Northern Ireland due to illegal smuggling. It did, however, raise the potential for further easements if given access to better-quality, real-time trade data on goods travelling from Britain to Northern Ireland. Additionally, it requested for Britain to complete building the border control posts at Northern Ireland's ports to facilitate the checks.

These proposals, however, are highly dependent on mutual trust, which is inherently lacking between both partners. Therefore, a bilateral agreement remains highly unlikely.

Thus far, the estimated general costs incurred by firms due to border controls stands at 6.0%, which accumulatively adds up to an additional hundreds of million pounds annually. The Consumer Council also reported that approximately 200 domestic firms have since seized sending its products to the Northern Ireland after Brexit.

State Aid and Subsidies

Currently, the UK government requires prior approval from Brussels before implementing any subsidies that will potentially impact the Northern Ireland's market.

However, since the clause was conceived before the signing of the Trade and Cooperation Agreement (TCA), which included the shared principles for subsidy control policy, the UK believes it should be reviewed and substantially relaxed. Brussels disagrees, and no proposals have been raised thus far.

Medicines

The UK raised that the protocol leaves medicines approved by the UK to not be equally available to patients in Northern Ireland.

The EU responded by unilaterally passing legislation to recognise the validity of UK-tested medicines. However, Boris Johnson again raised some outstanding issues relating to cancer drugs and insisted on a solution that is more comprehensive.

The medicinal and pharmaceutical industry remains key in post-Brexit trade as it accounts for up to £3.1 billion of bilateral trade between London and the EU in 2021. Moreover, the vast majority of drugs are manufactured in the UK. An increase in barriers and taxes on these products will erode the low profit margins of these medicinal manufacturers, negatively harming domestic businesses.

Rulemaking

Currently, the protocol falls under the jurisdiction of the European Court of Justice. However, Britain wants to push for a system where disputes are raised for international arbitration if unresolved.

The commission, however, insists that the bloc's top court must be the final arbiter since Northern Ireland remains subjected to the bloc's trading regulations under the protocol.

While we expect a compromise on both sides, a more specified dispute-resolution mechanism will have to be agreed upon to ensure equal standings for both parties.

Value Added Tax (VAT)

With the current protocol, Northern Ireland follows the EU's VAT regime which prevents Northern Ireland citizens from enjoying the benefits of UK VAT cuts.

However, Britain wants to set VAT rates for the country, without distorting that of the Republic of Ireland. This, however, has remained unresolved.

While Boris Johnson's government plans have received strong condemnation in Brussels, it is unlikely that the EU will implement trade reprisals. Nevertheless, updates on the negotiations remain key as pressure on both sides mount to resolve the deadlock. While a unilateral breach of the Northern Ireland Protocol can spell the end of trade cooperation between both parties, sending the UK further down on its path to recession, an amicable resolution can potentially mitigate some of the additional taxes and positively benefit businesses and trade in Britain. Moving forward, the situation will have to be closely monitored as we weigh in the new measures on the UK's economic outlook and trade flows.

Post-Brexit Economy

The first year of post-Brexit dealmaking saw the government falling short of delivering its promises of a better post-Brexit economy.

Thus far, post-Brexit bilateral trade deals signed (inclusive of those converted from EU-era deals) only cover just 64.0% of the UK's total trade. Although negotiations with U.S., India, Canada, and Mexico have been ongoing, the government still faces significant barriers to achieving its target. Notably, no significant deal has been made with U.S., which makes up 16.8% of the country's trade. Benefits from trade deals with India and improved relations with Canada and Mexico would only marginally benefit the country. Even if Britain successfully signs the deal and integrates into the transpacific CPTPP trading bloc, only an additional 0.4% and 1.5% will be contributed respectively to the target.

Economically, the decision to leave the Union remains a costly one. Trade barriers and additional taxes on goods transported from the UK to Northern Ireland has increased cost for firms by 6.0%. This translates to a total increase in costs of £600 million yearly.

In the medium term, the Fraser of Allander Institute projected Northern Ireland's economy to be 2.6%, equivalent to approximately £900 million, smaller than what it would been without Brexit. Firms in Northern Ireland may even shift to sourcing its materials from the UK to minimise costs.

In the longer term, the Office of Budget Responsibility projects that the UK's GDP will be 4.0% smaller than if it stayed in the bloc. This can be attributed to the forecasted 15.0% fall in imports and exports across the border.

As of now, Brexit remains as a political miscalculation that has brought more adverse economic impacts than benefits.

Fiscal Policy

In the Spring Statement, the government also introduced a slew of new measures to battle the spiralling inflation plaguing its economy. These were predominantly targeted toward its household to combat the soaring energy costs and economic uncertainty.

The main policies included:

Energy Bills Rebate

- One-off council tax rebate worth $150 to all households within bands A to D
- €200 up-front discount on this year's energy bills and repayable through five annual €40 instalments starting from 2023

Reduction In The Basic Income Tax Rate

- From Apr 2024, the tax rate will be lowered from 20% to 19%

Temporary Cut In Fuel Duty Fee

- Duty per litre will be lowered to 5p for 2022-2023

Additional Household Support Fund

- An additional fund of €500 million will be set aside in 2022-2023

With unabating increases in inflation, both domestically and globally, we expect to see persistent upward pressures on Britain's price indexes. More specifically, the European pivot away from Russian oil and gas will further inflate the prices of these commodities. This will spill over extensively into Britain's economy and directly impact Ofgem's new energy price cap in October, which is likely to increase substantially. In view of this, we expect the need for further fiscal subsidies in the coming months.

Figure 9: GBPUSD Chart

Source: Trading View

Figure 10: DXY Chart

Source: Trading View

Trade Idea: Short GBPUSD

In the first quarter, the BoE maintained its hawkish rhetoric with the implementation of four consecutive rate hikes to tame the soaring inflation. In the face of its hot labour market and surging energy prices, inflations are forecasted to hit 10.0% this year. The BoE will likely continue hiking interest rates in the near-term. While the GBP will appreciate from higher interest rates, we expect the aggressive rate hikes to substantially erode the UK's economic growth, negating the initial boost in GBP. This points to an overall depreciation of the GBP.

Moreover, the UK remains especially vulnerable to the risk of stagflation, compared to its G7 counterparts, due to its overly tight labour market and significant fall in trade after leaving the single European market. Currently, it has only covered 62% of its trade with free trade agreements, far short of its 80% target. The failure to reach a resolution in the Northern Ireland Protocol negotiations also increases the risk of political instability. The prolonged dispute continues to fuel business uncertainty as firms grapple with rising costs from trade tariffs. With trade between the UK and the bloc already being adversely impacted since its departure, the renewed tensions and mounting hostility have worsened the uncertainty in Britain's future trade flows. A trade war between Britain and the EU could potentially cut the UK off from its largest trading partner, derailing its economic recovery further in a time when recession risks are running high. On the global front, the economy also continues to grapple with the compounding effects of global supply chain disruptions with China's lockdown and skyrocketing energy prices. These underpins expectations of further inflation and weaker global demand, which in turn magnifies the risk of a major economic slowdown in the UK. These factors place further downward pressure on the GBPUSD.

With still-rising global inflation, volatile commodity prices, EU geopolitical uncertainty, China's continued lockdowns, and the Fed's front-loading of its tightening cycle, the risk-off sentiment is running high. The American dollar's status as a safe-haven currency signals continued USD strength as the global growth outlook deteriorates.

All these point towards a continued downward trend of GBPUSD.

Technical Analysis

The GBPUSD traded between 1.26 and 1.22 in the past two weeks.

The downward trending Moving Average Convergence Divergence and Moving Average lines supports our expectations of a further decline in GBPUSD. The Average Directional Movement Index of 35.15 indicates a strong downward trend of GBPUSD that is likely to continue.

Moreover, the upward sloping Moving Average Convergence Divergence and Moving Average line points towards the continued strengthening of the DXY, the U.S. Dollar Currency Index. This further supports the downward trend of the currency pair.

We would initiate a short at 1.25 and set out the take profit at 1.21 and stop loss at 1.27, which are within our support and resistant trend lines.

Entry: 1.25
Take Profit: 1.21
Stop Loss: 1.27
Risk Reward Ratio: 2.00

Disclaimer

NUS INVESTMENT SOCIETY

Global Macro Department –Russia (UNDERWEIGHT)

Date: 19th May 2022

Analysts

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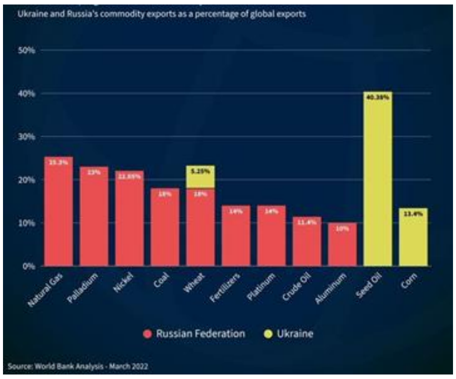
Basic Information

Real GDP (USD Trillion)	1.65 (2021)
M2 (RUB Trillion)	68.20 (Mar-22)
Current Account (USD Billion)	58.20 (Mar-22)
Core Inflation Rate (%)	20.37 (Apr-22)
CPI (based on 2015)	752.10 (Apr-22)
PPI (based on 2015)	282.30 (Mar-22)
Con. Confidence	-21.0 (Mar-22)
Currency	Russian Ruble (RUB)

Chart info

Figure 1: Russia's Energy Exports



Source: World Bank Group

Overview Of Sector

Russia, also known as the Russian Federation, is a country spanning the northern Eurasia region. The country operates under a mixed economy and uses the Russian Ruble as its national currency.

Russia's economy primarily consists of 3 sectors – service, industry, and agriculture. It is mainly driven by the service sector which accounts for 56.3% of the GDP, followed by the industrial sector which contributes 30.0% of the GDP. Crucial sectors of the service industry are comprised of financial services, communications, travel and tourism, advertising, marketing and sales, real estate, healthcare, social services, art and culture, IT services, wholesale, and retail trade and catering. The industrial sector consists of construction, electricity, mining, manufacturing, water, and gas.

As of 2021, exports and imports accounted for 33.0% and 23.0% of Russia's GDP respectively. Minerals, including oil and gas, make up 45.0% of Russia's exports, while machinery and mechanical appliances accounted for a third of Russia's goods imports. Overall, trade constitutes around 40.0% of the GDP. Its biggest foreign trade partners in 2021 were China, Germany, the Netherlands, Belarus, and the United States.

As an energy superpower, Russia accounts for a quarter of global natural gas exports, 18.0% of coal exports, and 11.0% of crude oil exports.

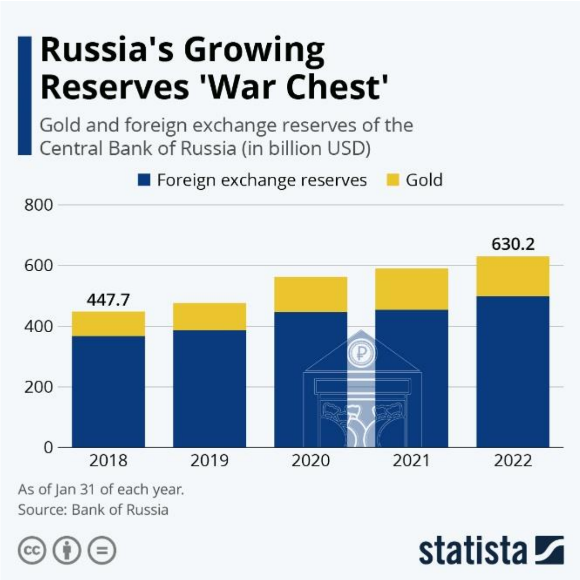
Russia saw its best GDP growth since 2008 in 2021, with a strong 4.7% growth rate. However, we expect this upward trend to be reversed in 2022 as its economy is forecasted to contract as much as 11.0% in face of the Russia-Ukraine war.

Summary Of Events in The Past 6 Months

- Following the invasion of Ukraine on Feb 24, Russian banks were removed from the SWIFT payment network and its foreign exchange and gold reserves were frozen
- The Ruble tumbled to record lows as the West tightened sanctions. In response, the Central Bank of Russia imposed strict capital controls and implemented an emergency hike of key rates to 20% to support its plunging Ruble
- U.S. imposed a ban on Russian oil and gas imports, while the UK pledged to phase out Russian oil by the end of 2022
- Russia demanded for 'unfriendly nations' to pay for Russian gas in Rubles but was rejected by the G7 countries
- With the escalation of tensions and the embargoes of Russian oil and gas under debate, energy prices skyrocketed, enabling Russia to benefit from windfall revenues
- In response to the declaration of a G7 pivot away from Russian energy, Putin retaliated by cutting off gas supplies to Poland and Bulgaria, signalling its willingness to weaponize energy against the West

- As the Russian economy stabilised, key rates were cut back to 17% in and down to 14% in April as the Ruble rebounded to pre-war levels
- As the May 25 expiry on the temporary license allowing transactions for Russian sovereign debt payments approaches, Russia faces a high risk of a debt default

Figure 2: Russia's Reserves



Source: Statista

Western Sanctions

In the three months since Russia's invasion of Ukraine, we have seen waves of draconian sanctions imposed on the former to penalise Putin's regime. The key sanctions include:

Financial Measures

- Russia's central bank foreign currency reserve, worth $630 billion, has been frozen and the Bank has been barred from repaying debt using the $600 million it holds in American banks, diminishing its ability to repay its international loans.
- Key Russian banks have been excluded from SWIFT, the global financial messaging system. This will hinder the payments for energy exports.
- Major Russian banks have been removed from the UK financial system with all Russian assets frozen. Russian firms will also be barred from borrowing money from the UK banks.

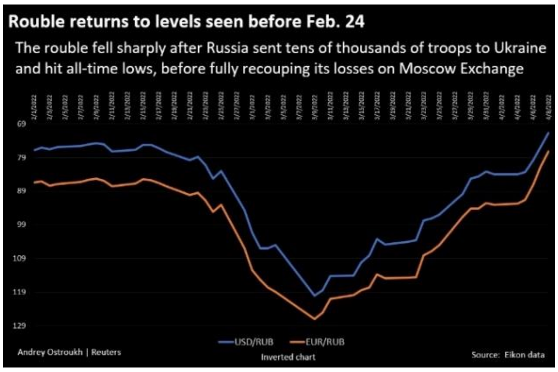
Russian Energy

- U.S. has banned Russian oil and gas imports, while the UK has pledged to phase out Russian oil from its economy by the end of this year
- Plans for the opening of Russia's Nord Stream 2 gas pipeline have been frozen indefinitely
- The EU will implement a ban on Russian coal imports by August

Additionally, the mounting criticisms have resulted in a corporate flight from Russia. Over 1,000 international firms have either halted investments in Russia or left altogether. These include industry giants such as Starbucks, Goldman Sachs, and Sony.

In retaliation, Russia has banned exports of over 200 products, including electrical equipment, medical, vehicle, telecoms, and timber, until the end of 2022. Interest payments to foreign investors holding Russian government bonds have also been blocked, and sales of Russian stocks and bonds by foreign investors have also been prohibited.

Figure 3: Ruble Fluctuations



Source: Reuters

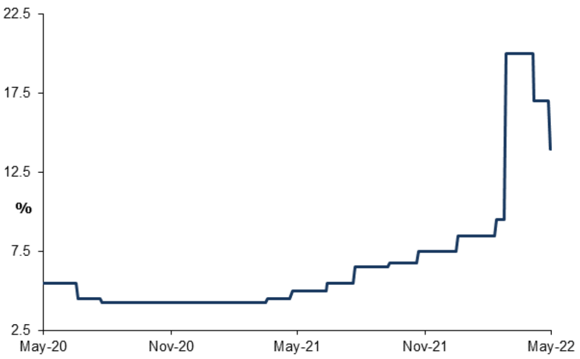
Central Bank of Russia

Following Russia's invasion of Ukraine on Feb 24, the Ruble plunged to record lows as the West heaped sanctions on the country and froze its foreign exchange and gold reserves. This prompted the CBR to increase its main policy rate from 9.5% to 20.0% on Feb 28 and introduce tight capital controls to deter flight capital and Ruble selling.

In a surprising turn of events, the Russian Ruble staged an extraordinary recovery from its previous losses against the American dollar through early May. Its unprecedented hike and draconian measures have effectively fended off the collapse of its financial system and pulled the brakes on the country's inflationary spiral.

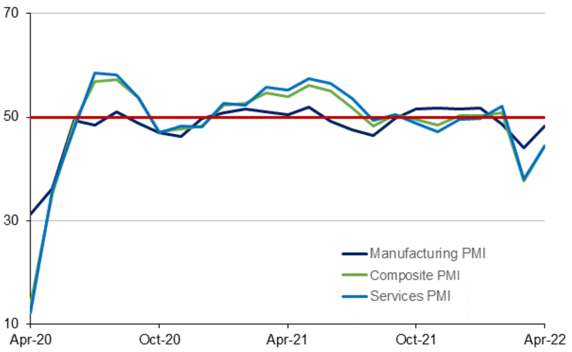
With the Ruble rebounding back to pre-war levels, the CBR slashed key rates to 17.0% on Apr 8 and subsequently to 14.0% on Apr 29. CBR's monetary easing reflects the nation's efforts to support the

Figure 4: Russia Monetary Policy Chart



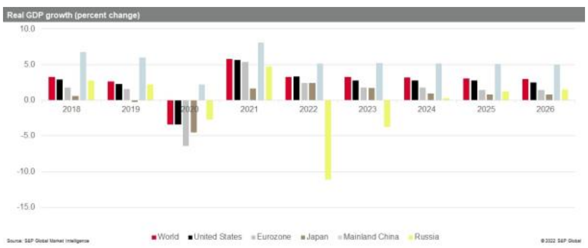
Source: Central Bank of the Russian Federation

Figure 5: PMIs Point to Shrinking Economy



Source: S&P Global

Figure 6: Real GDP Growth Forecast



Source: S&P Global Market Intelligence

contracting economy and encourage credit growth after withstanding the initial shockwaves of the sanctions.

With an outlook fraught with great uncertainty and volatility, the Bank has forecasted an annual inflation of 18.0-23.0% this year, before slowing down to 5.0-7.0% in 2023 and attaining its target rate of 4.0% in 2024. The Bank has likewise projected a contraction of 8.0-10.0% in its 2022 GDP, and a further 3.0% decline in 2023, before rebounding in 2024. Overall, the CBR will “take into account the need for a structural transformation of the economy” and “risks posed by domestic and external conditions and the reaction of financial markets”.

We anticipate the Bank to ease some capital controls in the coming months but will remain heavily dependent on intervention to support the exchange rate and overall monetary stability. There is scope for further rate cuts this year, so we are expecting a gradual decline in key rates for the rest of 2022 and 2023, against a backdrop of a recession.

A Looming Recession

Albeit Russia’s narrow escape from what could have been the nation’s worst banking collapse in the last three decades, Russia is set on a path toward a deep recession.

Evident in April 2022’s composite PMI of 44.4, Russia’s economy continues to shrink under the weight of the aggressive sanctions. The downbeat reports underscore weaker demand conditions due to the loss in purchasing power with the introduction of global sanctions and the drastic rate hike. Moreover, input price inflation has also clocked in the second-sharpest rise on record, prompting producers to significantly raise output charges. Lastly, business confidence and employment levels fell further in April amidst the heightened uncertainty. Its market also witnessed the mass exodus of almost 1,000 firms withdrawing and ceasing operations in Russia. All these factors support expectations of further contraction as consumers withdraw, and exports and investments plunge.

Bloomberg projects a slump in domestic demand by 14.6%, with household consumption and fixed investment down by 13.0% and 23.0% respectively. Altogether, Bloomberg’s GDP nowcast points to a decline of 2.0% in Russia’s GDP since the Ukrainian invasion began, which corroborates with the PMI figures.

This contraction, albeit a smaller one than predicted, can possibly be explained by the initial spike in domestic demand from panic buying, industrial inertia, and a delayed response of its domestic labour market. Moreover, the energy sector has largely escaped unscathed by the sanctions. These factors underpin our expectations of a slow erosion of Russia’s economic outputs instead of a complete stall.

However, with the continuous decline in output, compounded by the effects of supply-chain disruptions, weakened purchasing power, and tighter financial conditions, we expect Russia’s recession to deteriorate further. The S&P Global forecast reveals a contraction of over 10.0% this year. Likewise, Bloomberg projects the economy to contract 15.0% in 2022, and further decline by 3.0% in 2023, effectively wiping out 15 years of economic growth.

Russia's Lifeline - Energy

As the world's biggest exporter of natural gas, the second-largest crude oil producer, and the third-largest coal exporter, as well as the EU's leading supplier of gas, oil, and coal imports, Russian energy has been its economic powerhouse. However, its recent invasion has left the West turning their backs against its energy sector.

Insofar, U.S. and the UK have banned Russian oil imports. Commodity traders based in the EU and Switzerland have also stopped the sales of Russian state-owned Rosneft since May 15.

More notably, the EU, Russia's biggest oil market, has been attempting to increase economic pressure on Putin's regime by targeting its lucrative oil industry. The measures include:

A Maritime Financial Sector Cut-off:

The EU is in discussions for a potential ban on European firms providing services, including insurance, for Russian oil around the world. Although there has been some reluctance from the member states, it is expected to be passed.

This will significantly impact Russian oil exports that are transported using tankers since the key specialist insurers are predominantly based in the West. Collectively, insurers in the EU, the UK, Norway, U.S., and Japan cover 90.0% of maritime ships.

Without a valid Protection & Indemnity (P&I) certification, buyers of Russian oil will run the risk of running into claims worth hundreds of millions. This will most likely deter many from engaging in such transactions, effectively hampering Putin's attempts to shift towards the Asian market.

Russian Oil Ban By End 2022:

As part of Brussel's sixth package of sanctions, the commission is proposing a regional ban on Russian oil to undermine Putin's ability to wage war. However, it has faced much reluctance due to the crippling repercussions and concerns about regional oil security at a time when oil prices are skyrocketing.

Notably, Hungary hopes for an extended phase-in period of the ban as opposed to an immediate one to ensure it has sufficient time to secure alternative sources and conduct an orderly change in trade flows. It is also seeking additional financial support from the bloc to help pivot away from Russian fossil fuels. Other member states, like Slovakia and the Czech Republic, which are heavily reliant on Russian oil, are also expecting to receive special terms in their transition.

Opponents have also raised further concerns:

- **Logistical Constraints:**

Many Central and Eastern Europe land-locked countries depend heavily on Russian pipeline oil supply, making it significantly difficult to switch supplies swiftly.

Moreover, EU refiners have been designed for the Russian Urals, which differ in grade from those originating from the Middle East. A modification to these refineries would require substantial investments, which counters the region's environmental goal. With a tight global oil market, the OPEC also remains reluctant to aggressively tap into its spare production capacity, amplifying the region's fear of oil insecurity.

- **Effectiveness Of A Russian Oil Ban**

  Although the Russian budget is heavily reliant on oil export revenues, with it contributing 45.0% of its total income, a European oil ban may not be a sufficient penalisation. Perversely, the ban will further inflate oil prices, enabling Russia to recoup the costs of losing the European markets.

  The Kremlin only requires a price of $44 per barrel to break even and sanctions will make this even more possible. In April, Russian Urals saw an average monthly price of $70 a barrel. Despite being heftily discounted compared to the Brent prices, it was well above the Kremlin's budgetary needs. If a total EU oil ban is passed, Russia will only stand to benefit from even higher prices.

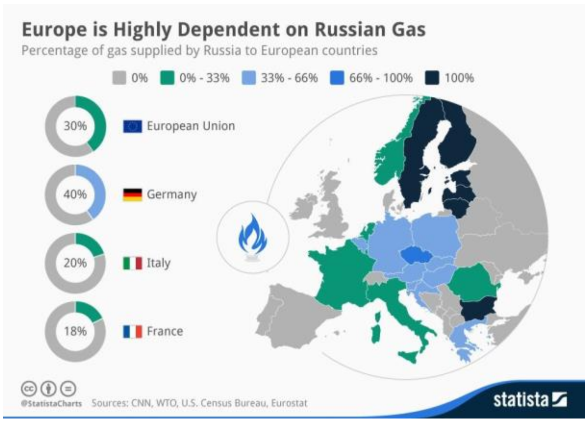
With Russia accounting for close to 26.0% of Europe's oil in 2021, it will be hard to wean off Russian oil within a one-year horizon. The implementation of an effective and coordinated blanket ban by Brussels will prove to be challenging but this potential ban will remain key to Russia's future outlook.

Putin's Retaliation

On Mar 23, Putin passed a law mandating Europe's energy payments to be settled in Rubles. However, Poland and Bulgaria, which have previously pledged to wean off Russian gas by year-end, refused to accept these terms of payments on the grounds that this would breach current contractual obligations. In response, Russia halted gas deliveries to both countries on Apr 27. Considering that both countries only account for just 6.5% of Russia's gas exports to Europe, the economic repercussions on Russia will be marginal.

This politically motivated move is unsurprising, especially in light of Poland's hawkish rhetoric towards Russia, and its unwavering support for Ukraine through the continued providence of heavy weaponry. Bulgaria, on the other hand, is a relatively insignificant customer of Gazprom in the European Union. Putin's hostile response reemphasizes the Kremlin's willingness to weaponize energy and the increasing likelihood of a gas cut-off to Europe.

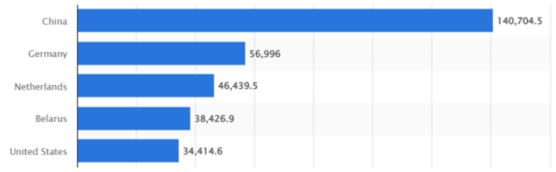
Figure 7: Europe's Dependence on Russian Gas



Source: Eurostat

In May, Gazprom announced it will stop the Yamal pipeline gas shipments to Europe after the Kremlin sanctioned the EU's gas companies. This retaliatory action pushed gas prices higher, with TTF, the European wholesale gas price benchmark, jumping almost 13.0%.

Figure 8: Russia's Leading Trade Partners in 2021, by value



Source: Statista

Figure 9: Leading Importers of Russian Fossil Fuels

Source: Financial Times

With 30.0% of Europe's gas derived from Russia, an abrupt gas cut-off will cripple these economies. Hence, it seems highly unlikely for the EU to completely wean off Russian natural gas in the near-term. Evidently, the Russian gas remains a key bargaining chip in Putin's advances.

Moving forward, key developments in Russia's oil and gas sector will be pivotal in Russia's economic outlook for the coming years.

Russia-China Trade: The Potential to Diverge

Over the last decade, Russia and China have strengthened their trade relations, particularly after U.S. and the EU sanctioned Russia following the annexation of Crimea from Ukraine in 2014. As of 2021, China was Russia's biggest trade partner, with total trade amounting to 140,704 million USD.

With multilateral sanctions intensifying amid the escalating Russian-Ukraine war, we should reassess the diversion potential of Russian trade to its traditional ally.

An Asymmetrical Trade Relation

While China accounts for a significant 15.0% of Russia's exports, this makes up less than 3.0% of China's total imports. Similarly, almost 24.0% of Russia's imports are from China, but this only constitutes 2.0% of China's total exports. With its status as Russia's largest trade partner and third-largest importer of Russian fossil fuels, the Chinese market remains indispensable to Putin's regime. On the other hand, Russia is a relatively smaller trade partner to China.

However, a sector China remains heavily reliant on is the Russian commodities. Mineral products make up 70.0% of China's total imports and over 10.0% of China's total mineral product imports. Similarly, Russia maintains its status as China's top crude petroleum oil provider, second at times only to Saudi Arabia. In 2021, Russia provided 79.65 million mt of crude petroleum worth USD39.5 billion, making up 15.6% of China's total crude oil imports.

Feasibility Of A CNY Based trade

With President Xi's paradigm shift toward financial openness and the internationalization of the use of RMB in foreign investments, cross-border trade settlement in CNY has risen to 20.0% of China's global trade currently. According to CBR's quarterly data, an estimated 27% of Russia's imports from China and 6% of Russia's exports to China were settled in CNY.

In view of the Ruble's current volatility, we expect CNY settlement to be preferred in bilateral trade transactions. In 2016, the PBOC and the CBR also signed an agreement to establish a CNY clearing mechanism in Russia, which will likely benefit trade with Russia and Chinese investments in Russia. However, its usage has been largely limited. ICBC's local transactions in Russia made up just 0.02% of its total assets in 2020. Only a single transaction amounting to RMB0.11 million was officially reported in 2018. The lack of continuity of its usage, coupled with the excessive fluctuations of the RUB underscores substantial limitations of this swap line.

China's Careful Dance With Russia And The West

As western firms pivot away from Russian commodity exports, there are rising expectations of an energy-hungry China stepping in to purchase the surplus oil. While major state-owned commodity traders have generally shunned away from signing new supply contracts in fear of western secondary sanctions, reports have revealed that some of China's independent refiners have taken over some of the state-owned firms' quotas for Russian oil and bypassed traditional methods to access discounted Russian oil while maintaining a low profile for Beijing.

Considering Russia's relatively smaller importance in China's trade links outside the energy sector, and the high scrutiny on its bureaucracy, one will have to weigh China's willingness to openly support Russia and risk worsening relations with the West.

Feasibility Of An Asian Pivot

Prior to the invasion, 60.0% of Russia's oil exports went to Europe – thrice that to China. This casts doubt on the appetite of China, and the Asian market, to fully absorb the fall in demand for Russian oil. Moreover, Russia's pipeline infrastructure has been mainly designed for transporting oil to the West. Moscow's sole gas pipeline to China is also operating at its full capacity already. Rail capacity has also been significantly constrained with the recent rise in coal export to the East after the EU's Russian coal import ban.

While the alternative of redirecting oil to Asian importers by sea remains, this requires super tankers making long journeys from the Russian Baltic and the Black Sea ports. Many shipping firms will shun away from handling Russian cargoes in fear of U.S. secondary sanctions.

In face of these logistical bottlenecks, and uncertain demand, it is evident that China alone remains an inadequate solution to the loss of exports from the European market. In 2022, we will expect bilateral trade between both countries to remain stable with limited diversion.

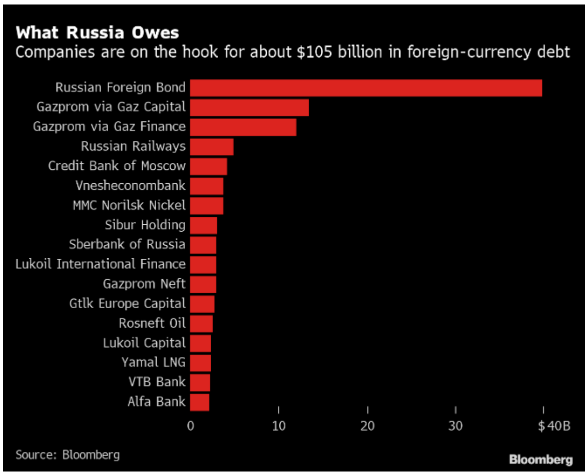
Although the short-term effects on Russia's economy remain bearable, the loss of the European market, and significant barriers to a total pivot to the Asian market will hit economic activity and the value of its Ruble in the long term. We expect most of these impacts to become increasingly visible in 2023.

A Looming Russian Default

With close to half of its foreign reserves held in overseas banks frozen by crippling sanctions, Russia finds itself ensnarled in a race to repay its $150 billion debts.

Insofar, Russia has narrowly averted historic debt defaults by fulfilling its sovereign debt obligations in March, and again in May. On 3 May, Moscow made payments for $650 million worth of dollar-

Figure 10: Russia's foreign-currency debt



Source: Bloomberg

denominated Russian sovereign bonds maturing in 2022 and 2042 to bondholders a day before it was due.

To date, Russia has been able to fulfil bond payments on Russian sovereign debt from sources authorized by the Treasury due to an exemption in U.S. sanctions by the U.S. Office of Foreign Assets Control (OFAC). However, with this exemption set to expire on May 25, and several Russian bond payments due on May 27, a Russian debt default may be triggered.

Evidently, despite Moscow's fulfilment of its latest obligations, probabilities of default by Morgan Stanley Capital International (MCSI) Research remain high – 67.0% over one-year, and 88.0% over five-year horizons.

Although we will not rule out the possibility of OFAC extending the general license for foreign debt service beyond May 25, it seems unlikely that this will happen as it will be "to the clear benefit of Russia". A more pertinent question would be whether the CBR can still avert yet another debt default without this extension.

Fiscal Policy

With the ongoing war in Ukraine and the growing list of sanctions slapped on Russia, we expect the budget balance to fall into a wider deficit in 2022.

Traditionally, Russia relies on its energy export revenue to prop up the budget. However, this is projected to contract in 2022 with the sanctions and will be predominantly spent on financing its military offensive in Ukraine and preventing an economic collapse.

With an estimated cost of war in Ukraine exceeding $20 billion a day for Russia, we expect a sharp rise in military spending this year. Exacerbated by the unfolding domestic recession, revenue will fall.

The prolonged offensive, along with the sanctions, will be excessively costly for the state budget. This will limit government spending in all other areas, including social spending. Furthermore, with Russia's banking sector at risk, the Kremlin will face increasing difficulties to finance its deficit and raise even domestic debt, which will increase as a share of GDP this year.

Even if the conflict in Ukraine ends in the medium term, the Kremlin will struggle with its public finances. We expect to see a consistently wider deficit in 2023-26 than in the previous decade.

Trade Idea: Short USD/RUB

Figure 11: USD/RUB Chart

Source: Trading View

Following the invasion into Ukraine, Russia was slapped with draconian sanctions by the West, sending the USDRUB to record highs of 110. This called for a drastic interest rate hike to 20.0% by the CBR, along with the implementation of tight capital restrictions on its economy. Russians were prohibited from selling Rubles and buying foreign currencies, while exporting firms were mandated to sell 80.0% of their foreign currency revenues. This created artificial demand for the Ruble, propping up its value and making it the best-performing currency this year.

With energy exporters converting windfall foreign revenue into Rubles and Gazprom's clients opening Ruble accounts to settle its energy payments like Putin demanded, the FX market has been experiencing a surge in demand for Rubles. Furthermore, Russian firms spooked by the seizure of the country's $600 billion international reserves are also increasingly turning to convert export revenues into Rubles to avoid the risk of similar sanctions. In the short term, we expect the rally of the Ruble to therefore continue, due to the capital restrictions on dollars and uncertainty amongst Russian businesses catalysing a strong rebound in demand for the Ruble instead.

Despite so, the rapid recovery has stoked new fears of the Ruble over-strengthening, which will threaten the Kremlin's budget revenue and export competitiveness. In just 5 days in May, the Ruble saw a 13.0% increase against the Dollar. In light of this, the CBR loosened capital controls on its exporters, allowing them to convert only 50.0% of their revenue into Rubles, down from the initial 80.0%. In spite of this, we do not foresee a substantial depreciation of the Ruble in the short term as Russian energy sales, one of the primary reasons keeping the currency supported, is boosted by strong seasonal demand and a high price environment.

All in all, we expect the USDRUB to continue in its downward trend in the near term, supporting our short-term short trade on the currency pair.

However, in the medium to long term, we do expect the USDRUB to revert back to its pre-war range of 72-75 as seasonal demand for Russian energy ebbs, countries that were originally dependent on Russian energy implement plans for alternative energy sources, and the effects of easing capital control actualise.

<u>Technical Analysis</u>

USDRUB has traded between 70.00 and 55.00 in the past two weeks.

The Exponential Moving Average and Moving Average Convergence Divergence lines reflect a downward trend. The lower Bollinger band also indicates that there is still room for a further decrease. These indicators, together with the support and resistance levels of the trade channel, support our proposed short trade.

We would initiate a short at 57.50 and set out the take profit at 48.50 and stop loss at 62.00.

Entry: 57.50
Take Profit: 48.50
Stop Loss: 62.00
Risk Reward Ratio: 2.00

Disclaimer

Analyst

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Basic Information

GDP (USD Billion)	301.924 (2020)
Interest Rate (%)	4.25 (Mar-22)
CPI	101.8 (Mar-22)
PPI	115.0 (Mar-22)
Con. Confidence	-13 (Feb-22)
Bus. Confidence	46 (Feb-22)
Currency	Rand (ZAR)

Chart info

Figure 1: South Africa's Annual Inflation Rate

Source: Trading Economics, Statistics South Africa

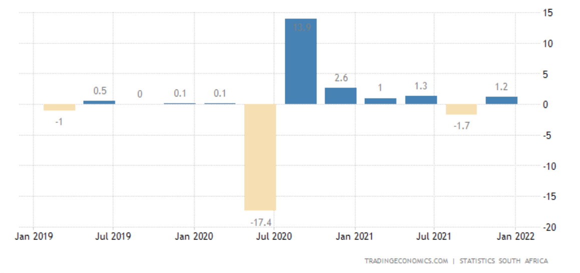
Overview of South Africa

- South Africa is an emerging market economy, being the third largest GDP in 2020 in Africa, after Nigeria and Egypt.
- South Africa is one of the most industrialized and technologically diverse economies in Africa.
- Known for its high unemployment of 34.9% and even higher youth unemployment at 46.3%, its unemployment crisis has been a sticky problem for many years.
- South Africa's recovery from the pandemic has been steady, but with the Omicron variant appearing locally in late 2021, a large increase in cases is making its recovery slower.
- South Africa's economy comprises of mainly exports. Main exports are from its mining sector, namely gold, platinum, iron ore and coal, and the manufacture of cars. Main export partners are China (15%), UK (8%), Germany (7%), United States (6%), and India (6%).

Summary of events in the past 6 months

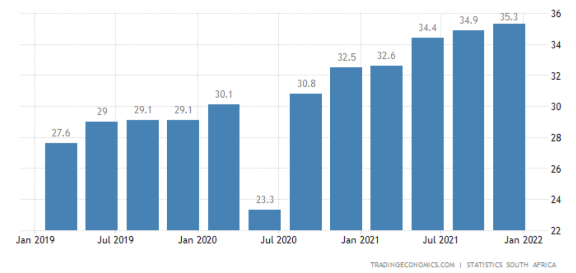
- Amid the pickup on Consumer Price Index (CPI), South Africa's Reserve Bank (SARB) has been raising interest rates during the last central bank announcements to combat inflation. The consensus related to interest rate change in May 2022 is an increase from 4.25 percent to 4.75 percent. The rate hikes have been happening as promised, South Africa's inflation remained reasonably benign given the persistently weak economy, but inflation was edging higher in January 2022 and the SARB's interest rate normalisation process was communicated to continue.
- Consumer prices rose 5.7 percent in January from a year earlier, meaning that inflation is close to the top of its target range. Markets were pricing in a quarter-point interest-rate hike in March, which materialised (Fig. 1). The annual inflation rate in March 2022 is 5.9 percent, slightly increased comparing it to the two previous months. Main upward pressure came from prices of transportation, food & non-alcoholic beverages and housing & utilities.
- South Africa remained abstain in March when the United Nation voted to condemn Moscow's attack on Ukraine. South Africa has not clearly positioned itself, but has been blaming the West for the problem rather than the Russians. The South African president said that the war could have been avoided if NATO understood the warnings from its own leaders over the years that its eastward expansion would lead to greater instability in the region.

Figure 2: South Africa's GDP Growth



Source: Trading Economics, Statistics South Africa

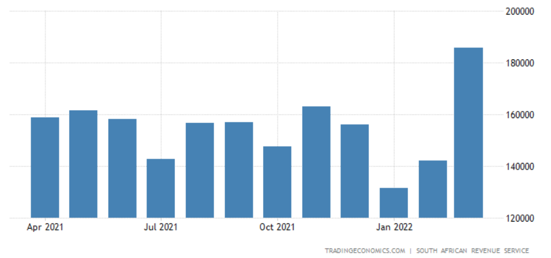
Figure 3: South Africa's Unemployment Rate



Source: Trading Economics, Statistics South Africa

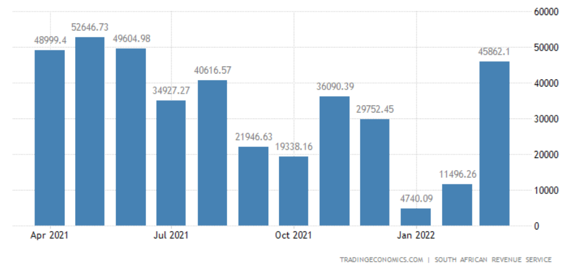
- South Africa was missing out on some of the riches on offer from the commodities boom as a rail network beset by problems hobbled its exports in May 2022. As a result, it could not participate in deals which would have otherwise supported its economy. The companies have now resorted to using trucks to transport coal to ports to satisfy the rising demand in Europe following the Ukraine crisis. The state-owned logistics institution, Transnet, has been faced with poor maintenance, copper cable vandalism, and a lack of spare parts for trains, disrupting their rail services. The poor services of the logistics company have directly contributed to a significant drop in iron ore and coal services.
- The Omicron variant of Covid-19 which first appeared in South Africa caused a scare in international markets, with many countries either restricting travel to and from South Africa or advising against doing so. This affected the South African economy significantly. New infections have started to continuously fall, thus South Africa eased COVID-19 measures in May 2022.
- As expected in January 2022, the pandemic and energy supply constraints affected investor confidence and job creation, especially in the recovering labour-intensive sectors.
- The South African GDP advanced by 1.2% quarter on quarter in the three months leading up to December of 2021, following an upwardly revised 1.7% contraction in the previous period and slightly below market estimates of a 1.3% rise (Fig. 2). Year-on-year, the economy expanded by 1.7%, slowing from a 2.9% growth in the prior period, matching market forecasts. Considering the full year of 2021, the South African economy expanded by 4.9%, the most in 14 years, recovering from a 6.4% decline in 2020.
- South Africa's unemployment rate climbed to 35.3% in the fourth quarter of 2021, up from 34.9% in the previous period. It was the highest jobless rate since comparable data began in 2008 and it rose further during the last period (Fig. 3).

Figure 4: South Africa's Export



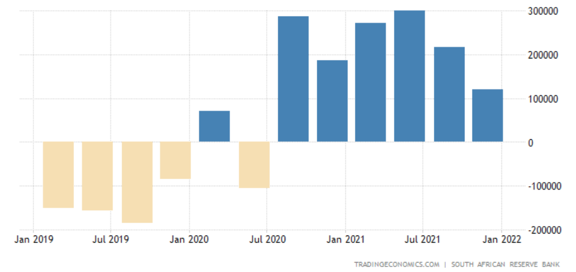
Source: Trading Economics, Statistics South Africa

Figure 5: Balance of Trade



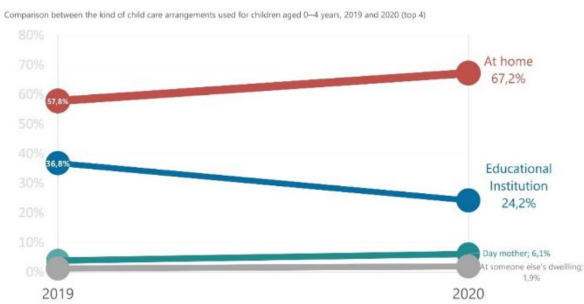
Source: Trading Economics, Statistics South Africa

Figure 6: Balance of Payments



Source: Trading Economics, Statistics South Africa

Figure 7: South Africa's Children Age 0-4 Educational Institution Attendance



Source: Statistics South Africa

External and Internal Effects

Commodities

South Africa is located far from the war but is affected through global markets. The currencies of emerging market commodities producers have performed relatively well this year as they are able to sell commodities for higher prices. (Fig. 4) Thus, the war may affect South Africa positively in this sense, as its commodities exports are similar to Russia and Ukraine and it can behave as a sort of substitute to these. Although, several importer countries of these commodities are still experiencing lockdowns, such as China. Furthermore, South Africa experienced a serious disruption in commodity export as its rail network had several problems. Thus, it is missing out on some of the riches on offer from the commodity boom in March 2022.

Trade Balance

South Africa's trade surplus widened to ZAR 45.86 billion in March of 2022 from an upwardly revised ZAR 11.5 billion in the previous month, the highest since June 2021 and well above market expectations for a ZAR 19.9 billion surplus. (Fig. 5) Exports surged by 30.9 percent month-over-month while imports rose at a much softer 7.3 percent. Considering the first three months of 2022, the country's trade surplus narrowed to ZAR 62.10 billion from ZAR 99.06 billion a year earlier, as exports increased by 9.8 percent year-on-year whilst imports increased by 21.3 percent over the same period.

The country exports commodities such as gold, platinum, iron ore and coal but it imports transportation, food & non-alcoholic beverages and housing & utilities. Thus, while it gains on exporting commodities which are priced higher because of the war, its import is also costly after the reopening of its economy. Although, all in all its trade balance grew significantly, it is worse than a year ago.

Balance of Payments

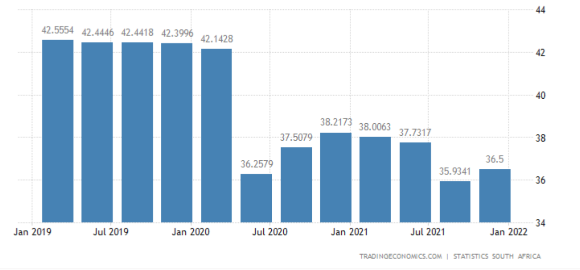
The current account surplus as a share of GDP is expected to remain unchanged at 3.8 per cent in 2021, supported by a robust trade surplus, as the value of merchandise exports grew faster than imports. (Fig. 6) This was mainly due to a strong performance in mining, which accounts for just over 60 per cent of total exports – particularly iron ore, rhodium and coal.

These net trade gains are expected to dissipate in 2022 as the prices of South African commodities ease over the short term and import volumes recover more substantially. The current account is expected to moderate to a marginal surplus in 2022 before moving into a deficit in 2023 and 2024.

Easing of COVID-19 Restrictions

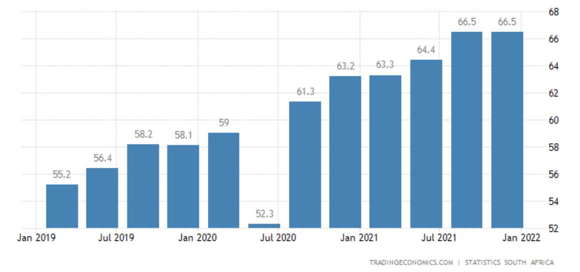
The Covid-19 pandemic has hit emerging markets harder, with South Africa imposing Covid-19 regulations that forced schools and educational facilities to shut down. The percentage of children attending childhood education decreased from 36.8% to 24.2% in 2020 (Fig. 7). The Covid-19 Social Relief of Distress grants supported families, and it became the second most important source of income in 2020. Vaccination rates were low for a long time and the Omicron situation worsened the problem in 2021.

Figure 8: South Africa's Total Employment Year-On-Year



Source: Trading Economics, Statistics South Africa

Figure 9: South Africa's Youth Unemployment Rate



Source: Trading Economics, Statistics South Africa

Now that new infections are decreasing, the government has started to ease the restrictions. South African President Cyril Ramaphosa announced in the end of April 2022 the end of the country's state of disaster, which was first brought on by the pandemic.

Unemployment And Job Crisis

Unemployment

The Congress of South African Trade Unions (Cosatu) has raised alarm bells over South Africa's record high unemployment rate which is steadily creeping towards the 50% mark. Data published by Statistics South Africa in March 2022 showed that the country's official unemployment rate rose 0.4 percentage points to a record 35.3% in the fourth quarter of last year. However, the expanded definition of unemployment is currently sitting at 46.2%.

Job losses are primarily observed in manufacturing and construction in the end of 2021. On the other hand, private households, trade and community and social services reported job gains. Employment rate decreased steadily in 2020 and remained extremely low until today (Fig. 8). The youth unemployment rate, measuring jobseekers between 15 and 24 years old, was unchanged at a record high of 66.5% (Fig. 9).

The trade federation also called for intervention in Transnet and metro rail which it says are necessary to get the country's mining, manufacturing, and agricultural products to their markets on time, helping to save and create jobs in those sectors. The state logistic institution, Transnet, has been faced with poor maintenance, copper cable vandalism, and a lack of spare parts for trains which disrupted their services causing significant losses. Education and capital allocation to these fields may be beneficial.

Education System

South Africa needs to improve its education system, which currently does not provide the skills that the job market demands. The current vocational system does not offer enough, and relevant technical skills and higher education and training are not linked to commerce and industries. Nzimande, the labour minister believes that the economic recovery plan proposed is crucial in creating jobs and intends to speed up the implementation of the plan. However, it is uncertain how effective the implementation will turn out.

Restrictive Labour Laws

South Africa's current labour laws are very restrictive which only poses hurdles to discourage businesses from proliferating in South Africa. We believe that South Africa will benefit from easing some restrictions in labour laws to increase employment opportunities through SMEs opening in the nation, and by reducing the friction costs experienced from employment and termination. There is a lot to gain from encouraging investments in human capital and if done right, South Africa could finally break free from its long unemployment crisis that has taken hold of the nation.

We believe that changes in labour laws or improvements in education are important developments to keep an eye on. The government has attempted to mitigate joblessness by providing additional funding for the presidential employment initiative in the 2021 Budget and expanded its employment tax incentive, but the efforts need to be supported by GDP growth and more employment opportunities.

Economy Under Uncertainty

Inflation

In December 2021 the inflation rate moved close to the target range which highlighted a difficult choice between price growth and sluggish economy support. The central bank has been rising interest rates cyclically and is expected to continue.

The headline CPI in March happened to be below consensus, inflation is expected to exceed the 6% threshold and prompt further rate hikes.

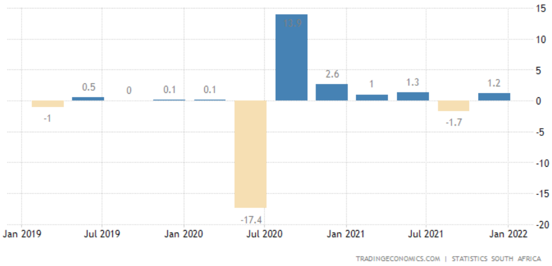
The main two effects on inflation in South Africa are the Chinese supply chain shocks and increased domestic prices after Covid measures are eased. The Chinese supply shock because of the lockdown in the country results an upside risk to imported inflation while increasing prices mostly driven by food prices is another upside risk for inflation in food prices.

GDP Growth and Economic Activity

After the resurgence of COVID-19 infections towards the end of 2021, the International Monetary Fund (IMF) lowered its expectation for global growth in 2022 from 4.9 to 4.4 per cent. The National Treasury projects real economic growth of 4.8 per cent in 2021 and 2.1 per cent in 2022 in South Africa. Due to structural constraints, the economy started off the Covid pandemic with a recession which is important to note when the aim is to get back into pre-pandemic level of GDP (Fig. 10).

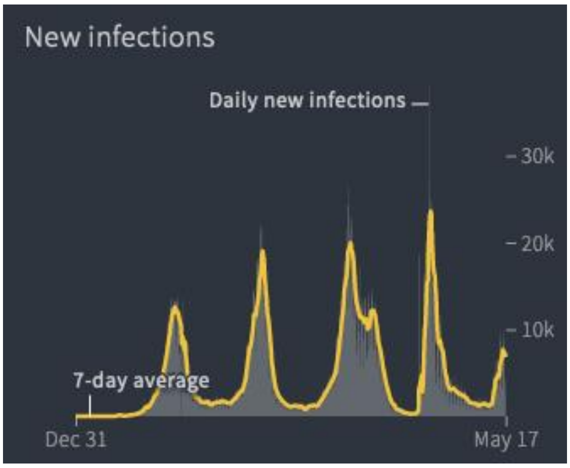
Global uncertainties and an uneven domestic recovery will weigh on the economic outlook over the medium term. While the outlook for 2022 has been revised upward, persistent structural constraints continue to inhibit the pace of the recovery from COVID-19 and longer-term growth. Daily new infections are decreasing again (Fig. 11). Accelerated implementation of reforms is necessary to create jobs and encourage investment over the medium term.

Figure 10: GDP Growth Rate in South Africa



Source: Statistics South Africa

Figure 11: South Africa's Covid Cases



Source: Reuters

Trade Idea: LONG ZAR/EUR

Figure 12: TradingView ZAR/EUR YTD Chart

Source: Trading View

Narrative

The COVID-19 situation is becoming less severe in South Africa, it is likely that inflation persists even if the central bank is increasing rates cyclically. This is also because of the indirect effects of the Russia-Ukraine war, as the war affects prices of products which are imported by South Africa. But prices of some products which are exported and can be substitutes to Russian products is also increasing, which may mitigate some of the losses. Despite such income, the country will probably experience high inflation for the next period.

As the global situation in the economy is relatively more uncertain again since the war erupted, investors may shy away from emerging economies' currencies, such as the South African Rand. Thus, the general sentiment may be a short position in the ZAR instead, allowing us to take a contrarian position that could reap high rewards.

Eurozone in high uncertainty

The Russian-Ukraine war is affecting Europe more directly as most of the oil and gas coming to Europe is from Russia. The US has been suspending much of its trade with Russia, and Europe has pushed through certain bans too. But they have to be careful as if they push it too far, their economy may suffer even more. Rate hikes are expected from the ECB, but may not help enough if energy prices are increasing further. Overall, the eurozone is having a rather uncertain period with a highly uncertain outlook.

If the situation continues, we believe that the EUR is likely to go down, despite the efforts of the ECB. If there were some improvements in the sense of solving the conflict between Russia and Ukraine, the eurozone may experience an improvement too. Currently, the war situation does not seem as though it will dissipate very soon, thus the argument that Europe is expected to struggle in the next period.

Europe vs. South Africa

Even if ZAR is considered a risky asset, the EUR is very much unpredictable. Relatively, the EUR is expected to do worse than the ZAR as although South Africa's import grew quickly, their income from selling products which are substitutes to Russian products is also growing. As this income may mitigate inflationary issues, the country may do relatively better compared to its own development.

Upcoming news from Europe may impact the EUR negatively and news from South Africa are expected to affect their currency positively. All things considered, we believe that the ZAR will strengthen in comparison to the EUR moving forward.

<u>Technicals</u>

The resistance lies around 0.0632, while support lies around 0.0546 (Fig. 12). There appears to be a less strong resistance line.

<u>Trade</u>

The trade idea is to long the ZAREUR pair. We expect the support line to remain strong even if it were to retest, hence our stop loss will be just above the support line. Any positive catalyst or simply a retest to the higher resistance level will reward this trade. The stop loss is near the support line, volatility or any perceived good news regarding the eurozone may cause this trade to fail. As there is much uncertainty in South Africa and Europe, volatility poses the greatest downside risk to our trade.

Entry: 0.0590
Take Profit: 0.0605
Stop Loss: 0.0580
Risk Reward Ratio: 1.5

Disclaimer

NUS INVESTMENT SOCIETY

Global Macro Department – Turkey (UNDERWEIGHT)

Date: 19th May 2022

Analysts

Valentina Misi
Global Macro Analyst
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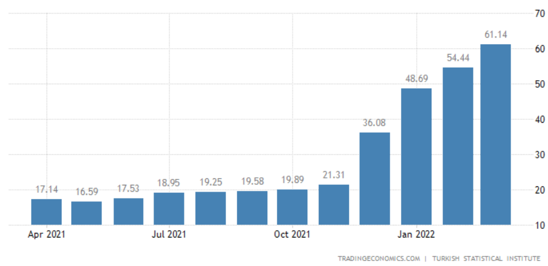
Basic Information

GDP (USD Billion)	720.101 (2020)
Interest Rate (%)	14 (Dec-21)
CPI	843.64 (Mar-22)
PPI	1,321.9 (Mar-22)
Con. Confidence	72.5 (Mar-22)
Bus. Confidence	108.5 (Mar-22)
Currency	Turkish Lira (TRY)

Source: Trading Economics

Chart info

Figure 1: Turkey's Annual Inflation Rate



Source: Trading Economics, Turkish Statistical Institute

Figure 2: Turkish Lira TRYUSD Since 2017

Source: Trading View

Overview of Turkey

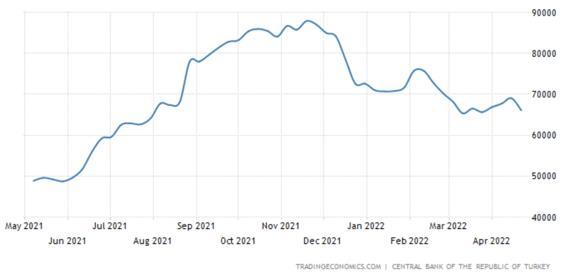
- Turkey is regarded as an emerging market economy, that is dependent on foreign denominated debt to fuel growth.
- The ruling party Justice and Development Party (AKP) is known for its more authoritarian approach, with the president Recep Tayyip Erdogan favouring aggressive foreign policy and an unorthodox monetary policy, believing that lower interest rates help reduce inflation.
- Known for its high inflation in the past 4 years (Fig. 1), Turkey is experiencing a debt and currency crisis since 2018, with its Turkish Lira devaluing greatly over time (Fig. 2).
- Turkey has enjoyed strong economic growth over the last 20 years but it has been driven by debt-fuelled infrastructure spending which creates imbalances.
- As its economy relies on foreign currency denominated imports to produce many of its exports and local goods, there is growing vulnerability experienced by manufacturers, farmers and retailers caused by worsening inflation and increasing global commodity prices.
- Turkey's major exports were road vehicles, textiles, iron and steel, clothing and food, while imports were machinery and transport equipment, manufactured goods, mineral fuels and lubricants and chemicals. The biggest trade deficits were recorded with China, Russia, Germany, South Korea, Switzerland, India, Iran and Japan; and the largest surpluses were recorded with Iraq, the UAE, the UK, Israel, Syria, Northern Cyprus and Azerbaijan.

Summary of events in the past 6 months

- Deteriorated overall national economic outlook is fuelled by extremely high inflation, increasing unemployment, trade balance drop and sharp decrease in foreign reserves. Worsening geopolitical tensions and supply bottlenecks put extra pressure on the already difficult situation.
- In December 2021 the central bank cut interest rates from 15% to 14% as a result of Erdogan's ideas. Since then the interest rate has not been changed and is expected to remain the same for the next month. Erdogan's belief is to combat inflation in this unorthodox way which will most probably not work. The central bank left interest rate at 14% for the 4th time since the decision made in December 2021. Inflation in the recent period has been driven by rising energy costs resulting from geopolitical developments, temporary effects of pricing formations, strong negative supply shocks caused by the rise in global energy, food and agricultural commodity prices. The Committee expects disinflation process to

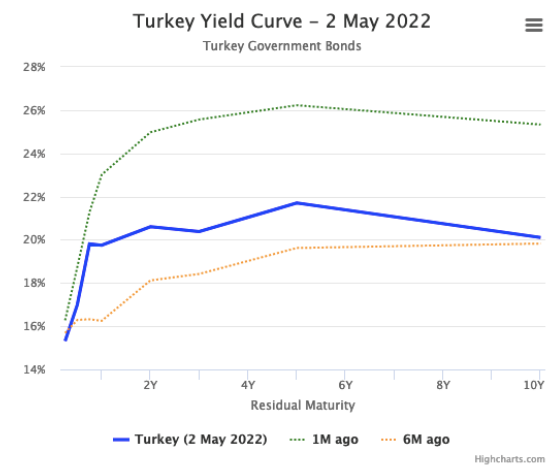
start on the back of measures taken and decisively pursued for sustainable price and financial stability along with the decline in inflation owing to the base effect and the resolution of the ongoing regional conflict. The central bank continues to use all available instruments decisively within the framework of Lira-ization strategy until inflation falls and the medium-term 5 percent target is achieved.

Figure 3: Turkish Foreign Reserves



Source: Trading Economics, Turkish Statistical Institute

Figure 4: Turkish Yield Curve



Source: Highcharts.com

- After this interest rate cut, inflation increased further and reached its historical peak in 19 years with CPI 36.08% in December 2021 and since then reached a 20-year's record high with CPI 61.14% in March 2022.

- The interest rate cut resulted the TRYUSD to drop at least 40% in December 2021. Erdogan replied to this by directly stopping people converting TRY to USD by topping up their account to maintain USD value deposits. As TRY fell tremendously, the central bank sold a large amount of foreign reserve currency, mainly USD, resulting almost halving its foreign reserves but artificially increasing demand for lira. (Fig. 3) It worked until they run out of lira and it depreciated again. In January 2022 Turkey signed a currency swap deal with the United Arab Emirates, boosting dwindling foreign-exchange reserves depleted by the country's financial turmoil. Furthermore, in February 2022 Erdogan decided to request gold from citizens to exchange for TRY with which the central bank could buy USD and could convert that to TRY to push up demand again. This does not seem to work out at all as people do not trust in the government.

- On the top of the already existing internal problems the Ukraine-Russian war puts a great pressure on the economy. Global risk appetite is becoming lower so does the demand for the Turkish Lira.

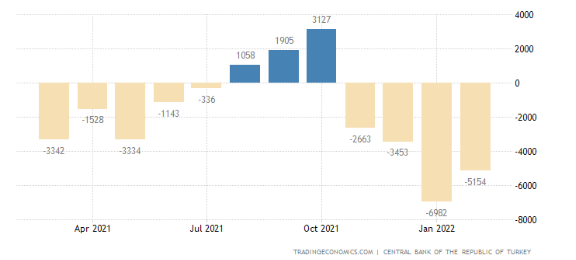
- The consumer confidence indicator in Turkey fell by 7.3% to 67.3 in April of 2022 from 72.5 in the previous month, the lowest since the series began in 2004. The manufacturing confidence index in Turkey rose by 1.2 points from to previous month to 109.7 in April of 2022. Significant improvements were recorded for sentiment regarding the general business situation (83.6 vs 79.2 in March), Fixed investment expenditure (129 vs 124.4), and the current amount of stocks of finished goods (97.9 vs 95.8). Meanwhile, expectations over the next three months deteriorated regarding volume of output (123.5 vs 125.9), employment (113.9 vs 115.8), and exports orders (123.4 vs 124.1)

- Turkey posted a trade deficit of USD 7.88 billion in February of 2022, widening from the USD 3.35 billion gap in the corresponding period of the previous year amid rising commodity prices and a falling lira. Imports grew by 44.5 percent to USD 27.9 billion

- The Turkey 10Y Government Bond has a 20.100% yield. 10 Years vs 2 Years bond spread is -50 bp. Yield Curve is inverted in Long-Term vs Short-Term Maturities. (Fig. 4)

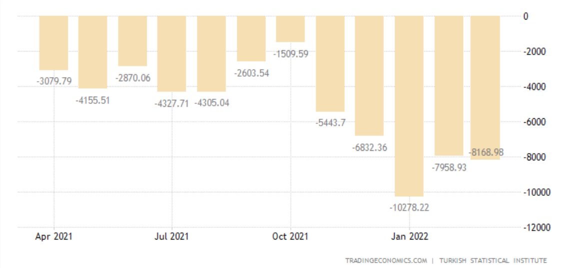
- The seasonally adjusted unemployment rate in Turkey was at 10.7 percent in February of 2022, the lowest in eight months and falling from a downwardly revised 11.2 percent in the previous month.

Figure 5: Turkey's Current Account



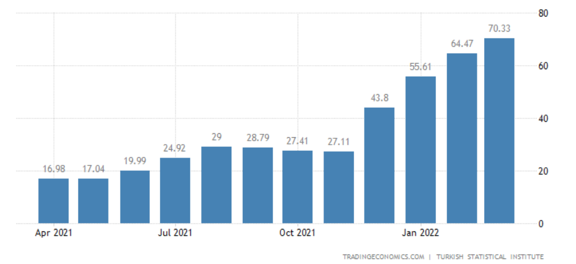
Source: Trading Economics, Central Bank of the Republic of Turkey

Figure 6: Turkey's Balance of Trade



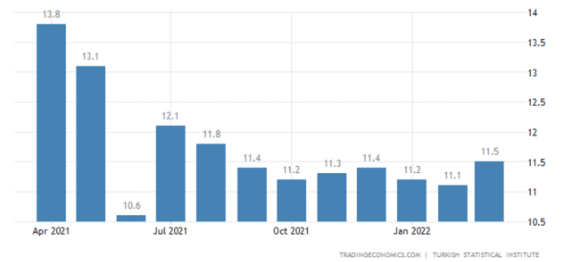
Source: Trading Economics, Turkish Statistical Institute

Figure 7: Turkey's Food Inflation



Source: Trading Economics, Turkish Statistical Institute

Figure 8: Unemployment Rate in Turkey



The Economy and People

Current Account Surplus and Narrowing Trade Deficit

After Turkey's current account surplus for 3 months in a row, it is experiencing a significant deficit (Fig. 5). The current account deficit widened year-on-year and has been below market expectations lately. The goods deficit is more than double relative to last year, and the secondary income surplus narrowed. The services surplus almost doubled and the primary income gap is down.

The trade deficit has been widening as well by comparing it to the last year's trade balance (Fig. 6). The strong decline in the first quarter is resulted by a higher jump in import than export, mostly because of the higher commodity price and falling lira.

The expectation before the decline in Q1 was that tourism and transportation sectors will recover after the pandemic for summer and the trade deficit can narrow further. The post-covid area and the war resulted different outcomes.

Import Prices and Cost of Living

As an emerging market, Turkey is greatly affected by the global supply shortages as it imports most of its raw materials to produce its exports and local goods. As the Turkish Lira is weak, imports costs more for manufacturers. The cost of food in Turkey increased by 70.33 percent in March of 2022 over the same month in the previous year. (Fig. 7)

Over the last 15 years, Turkey has had the highest rate of growing energy demand amongst countries in the OECD, with energy imports totalling USD 41 billion in 2019. Turkey's imports of Liquified Natural Gas have also increased in 2020, now representing 29% share of the market. Turkey is aware of this dependency and has energy exploration initiatives in the Eastern Mediterranean and Black Sea, although it may take many years to reduce this dependency. In the current crisis the situation is worsening.

GDP

The Turkish economy expanded 1.5 percent on quarter in the last three months of 2021. Projections about the following months may be less appealing concerning the current inflation and war situation. Borrowing costs are still relatively low because of the low interest rates but inflation may eat up the benefits of it.

Quality Of Life and Decent Work

Decent work and quality of life in Turkey in general is poor. Unemployment rate dropped to 10.7% in February, while a seasonally adjusted measure of labour underutilisation fell 0.9 percentage points to 21.8% in April 2022. This measure peaked last time in January 2021 under the COVID-19 measures.

The seasonally adjusted unemployment rate in Turkey rose to 11.5 percent in March of 2022 from the upwardly revised, eight-month low of 11.1 percent in the previous period (Fig. 8). The number of unemployed increased, while the labour force participation rate was slightly higher from the upwardly revised percent in February. The youth unemployment rate, measuring employment for individuals aged 15-24 increased.

In Turkey, the unemployment rate measures the number of people actively looking for a job as a percentage of the labour force. The forecast of unemployment overshoot in February 2022 and undershoot in the consecutive month. The current consensus suggests a slight further increase compared to the 11.5% in April 2022 to 11.7% in May 2022.

As the OECD country with the tenth highest level of relative poverty in 2019, many Turks engage in work that does not qualify as decent work. This is also the case for the refugees since they are likely to fall below the poverty line too. Engaging in informal work then increases their vulnerability due to its instability and insecurity.

With the currency crisis worsening every month, Turks are especially exposed to rising prices of imported goods and produced goods, and being unable to rely on their own currency and uncertain supply of affordable basic necessities like food, the people will demand more support from the government as relief. We believe that this negative feedback cycle will put pressure on producers and prices further, threatening economic growth, and its people.

Development In Geopolitical Relations

European Union

The EU summit last year in March 2021 reaffirmed that the EU still has economic interest to maintain and improve its relations with Turkey. However, the EU has been firm on its stance that it disagrees with AKP's "erosion of democracy and rule of law". In its annual report this year, the EU argues that Turkey's autocracy and continued violations of membership criteria have been detrimental to the progress of its membership.

Erdoğan has called on the European Union in May 2022 to further deepen their relationships. He emphasized that the war in Ukraine have reaffirmed how important Turkey is for the European Union from a strategic perspective. He believes that they shall focus on common denominator between them rather than their differences and said that Turkey's full membership is a requirement for the bloc's future.

United Arab Emirates

Already before 2022 the United Arab Emirates made efforts to rectify past disputes with Turkey regarding the Eastern Mediterranean and Gulf. Memorandums of Understanding were signed between Abu Dhabi Development Holding, Turkish Wealth Fund and the Turkish Presidency Investment Office, which aims to improve financial cooperation between the nations before 2022.

In January 2022 Turkey signed a currency swap deal with the United Arab Emirates (UAE) when Turkey was in trouble. In May 2022 they have officially launched talks on a Comprehensive Economic Partnership Agreement (CEPA), which is expected to double trade between the two nations. The plan is to cut tariffs, promote free trade, facilitate capital flows and reduce trade barriers in order to make business easier between the countries.

United States

Last time, in 2019, Erdogan visited the White House and held meetings with the president. In 2021 relations between the United States and Turkey were at an all-time low, with no new developments between the nations.

Russia

Political relations between Turkey and Russia are controversial but are sustained with strong economic ties. They have common features such as their view on Western policies inactivity over serious issues. The greatest difference between the two countries is their foreign policy related to Syria. Turkey did not support the country while Russia provided military, diplomatic and political support to keep the president in power.

There is energy interdependence between the countries which makes them to solve disagreements. Russia needs Turkey's geopolitical position to gain access to the Black Sea Region, and Turkey needs Russia because of its natural gas imports.

Turkey banned Russian armed forces from using its airspace to reach Syria in a bid in April 2022 to increase pressure on Vladimir Putin as Ankara tries to revive peace talks with Ukraine. Such steps are risky as it may lead to an increasing tension between them threatening natural gas supply to Turkey.

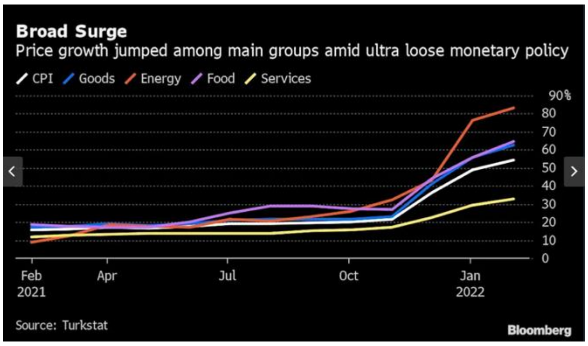
Currency Crisis Continues In 2022

During late history, Turkey has been using foreign loan to fuel growth and it has not been much different once they started to handle the COVID-19 situation, as foreign cheap loans have been used to support their economy. This suggests a continuity in terms of financing expenses, and the usual expansion in foreign reserves.

Based on Erdogan's idea, interest rate drop leads to lower inflation. After the reopening of the economies globally following the severe COVID-19 measures, the central bank in Turkey is combating elevated inflation by lowering the key interest rate. Inflation first rose because of the supply chain bottlenecks after the re-openings of economies, then increased further since the Ukraine-Russian war erupted. The crisis started in 2018 and was caused by excessive current account deficit and large amounts of private foreign-currency denominated debt, increasing authoritarianism and unorthodox ideas about interest rate policy.

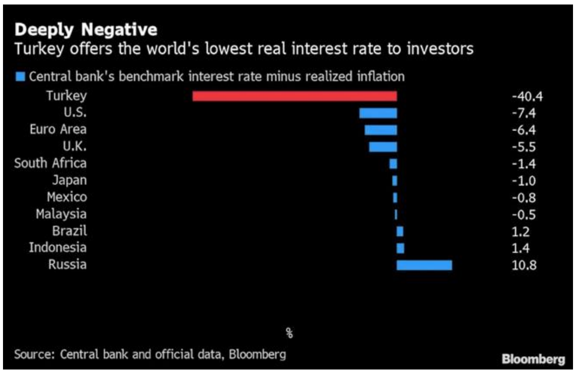
Amid the COVID-19 pandemic, the Turkish lira plunged to all-time lows following the replacement of Central Bank chief who slashed interest rates from 19% to 14%. As a response, the lira lost 44% of its value. Since then the situation became worst as the rate is kept unchanged but inflation has been rising immensely. Inflation (CPI) reached 61.14% in March 2022 with 85% rise in energy prices. (Fig. 9) The real interest rate - interest rate minus realized inflation - in Turkey has recently become -40.4%. (Fig. 10)

Figure 9: Price Growth Jumped



Source: Bloomberg

Figure 10: Lowest Real Interest Rate Offered by Turkey



Source: Bloomberg

Failure To Protect the Lira

The government released a 3-year roadmap for the Turkish economy in 2021 in which Turkey's economy was expected to grow by 9% in 2021 and to expand further by 5% in 2022. Furthermore, the government was aiming for growth of 5.5% in 2023 and 2024. Inflation was expected to cool down to 9.8% by the end of 2022. The current account deficit was projected to decrease as well. Although almost the opposite is happening. Inflation rose tremendously and current account deficit has been increasing.

After the central bank cut interest rates in December 2021, trust in Turkish Lira dropped and it has been decreasing as there is no proper answer on inflationary pressure from the government. As Erdogan believes in decreasing inflation by decreasing interest rates, he responded on the situation by stopping people spending TRY on USD via maintaining USD denominated deposit value TRY on bank accounts by topping them up with the necessary amount to encourage households to keep TRY. The central bank had to sell USD in order to be able to have enough TRY and boost lira demand in value artificially until they run out of foreign exchange reserves. Thus, demand dried up again and the lira started to depreciate. As inflation is rising because of such an answer plus the global inflationary pressures, the government has to top up the currency protected lira deposit accounts with even higher amounts.

Gold As an Exchange To Lira

Based on the newest plan, the central bank has been requesting citizens to supply gold for an exchange of lira. Gold would contribute to the central bank's reserve while citizens would use a more stable currency. Although, citizens are not that easy to be convinced about the government's ability of not losing value of the currency again.

Ukraine-Russia War Impact on Lira

Until the Russian attack on Ukraine TRY was hold in a tight band via costly interventions in the foreign exchange market and the lira protection scheme. When volatility returned in late February, the Turkish Lira depreciated massively to USD. Its value declined to its weakest since December in March because of the concerns of the war. One of the main results of the conflict so far is the increasing inflationary pressures and current account risks for Turkey.

Under the Lira protection scheme, the Treasury made up for the difference between the return on lira deposits and the currency's depreciation. The currency's depreciation is higher than periodic yields which makes the scheme less sustainable.

Russia and Turkey: An Ambiguous Energy Partnership

There are controversial political relations between Turkey and Russia but their economic ties are rather strong. This sort of relationship can easily create extra tensions, as it is stable only from economical perspectives.

Both the Turkish and Russian are having leaders who distrust European policies. Although, they are very different when it comes to political experience and worldviews. In the energy sphere, both countries have strong ties. Turkey is energy-dependent through the extended gas imports from Russia, and Russia needs Turkey for its geopolitical position, which makes Turkey a transport and a consumer country. Turkey is the second most valuable market for Russian gas but most elites don't want Turkey to be energy-dependent on Russia, which accounts for most of Turkey's trade deficit with that country. Turkey's target is to diversify supplies such as natural gas and greater goal is to be important it to be a "gas hub".

In conclusion, Russia needs Turkey's geopolitical position to gain access to the Black Sea Region, and Turkey needs Russia because of its natural gas imports.

Trade Idea: SHORT TRYUSD

Figure 11: TradingView TRYUSD YTD Chart

Source: Trading View

Narrative

The Turkish economy has been worsening after its seemingly improving economy in 2021 Q3. The outlook of the country is very pessimistic with an extremely high inflation rate with a dependent central bank unwilling to increase interest rates. External factors such as the war in Ukraine put even more pressure on the Turkish economy. Its currency is lowering in value relative to several currencies.

In the meantime, the Federal Reserve in the United States has started to increase interest rates which results a more appealing currency to investors. The interest rate increase pushes the USD up, so it appreciates relatively. Several rate hikes are priced in, although, as the situation in the US is very bad, there may be surprises with even more significant hiking.

The exchange rate differential is expected to widen which indicates the TRY to depreciate further relative to the USD. The Turkish and the US economy are both in a bad situation but their presidents are reacting very differently on inflationary changes.

Technicals

There has been a further decline at the beginning of May and we expect the situation Turkey to not to change in the upcoming period. The FED is expected to raise rates again which will most probably cause a further decline of the pair. The recent resistance level is at 0.0557 (Fig. 11).

Trade

This trade idea is riding on the decline in Turkish Lira that is expected to continue after the next FED announcement. The trend will likely continue unless there is a rate hike in Turkey. If such an emergency rate hike occurs, this trade may fail, hence we set our stop loss at the recent resistance level which will limit our losses early on should the price go up. Take profit is at a new low, 0.06389.

Entry: 0.06236
Take Profit: 0.05727
Stop Loss: 0.06389
Risk Reward Ratio: 2.8

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