The Weekly Update: Investor concerns about the growth outlook intensifies

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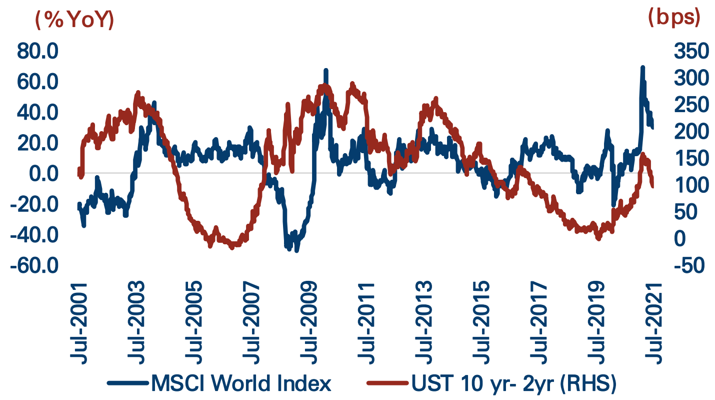
Trading environment:

- Global investor concerns about the outlook have increased considerably that is visible in the flattening bias in the US yield curve, strength in safe-haven currencies, volatility in global equity markets and downtrend in commodity prices
- Several triggers can be attributed to the capitulation in risk sentiment such as rising infections, the delta variant of the virus, an increase in restrictions in several Emerging Economies (EMs) and concerns about the pace of the Developed Market (DM) recovery
- In the near-term, we think that concerns about the global growth outlook could persist that could weigh on risk sentiment. However, our medium-term constructive outlook on global growth remains in place
- We maintain our USD bullish outlook. EM FX will continue to remain vulnerable to depreciation pressures. DM FX, with the exception of the JPY, could also trade with a depreciation bias against the USD
- The aggressive pace by which the US sovereign yield curve has flattened has come as a surprise that we do not think will reverse in a hurry. Fed Chair Powell clarifying that a move towards tapering is not imminent may also work to keep longer-end yields in check. In short, we see limited upside bias in longer-term US yields in the near-term
- In the local markets, we expect the USD/INR pair to move in sync with overall global risk appetite. More upside cannot be ruled out in the near-term. However, the INR is expected to remain an outperforming EM currency
- In the local bond markets, sharp rise in yields is unlikely given the RBI's bond buying programs such as the Government Securities Acquisition Program 2.0 (GSAP) that are still in operation as well as the pass-through of recent global developments
- The main events for the week are:
    1. Bank of Indonesia policy rate decision (22-July-2021): We expect the central bank to maintain status quo and provide a dovish guidance given that Indonesia has become the new epicenter of the COVID-19 strain and government officials are considering extending lockdowns currently in place
    2. European Central Bank (ECB) Policy Meeting (22-July-2021): We expect the ECB to move forward to incorporating its new framework and continuing to provide a dovish guidance. We expect the central bank to maintain its accommodative framework and keep its guidance on the Pandemic Emergency Purchases Program (PEPP) unchanged
    3. UK Retail Sales (22-July-2021): We expect a sequential improvement in June reflecting an improvement in mobility
    4. DM PMI flash surveys (23-July-2021): Investors will pay close attention to these PMI surveys to assess the strength of the recovery especially considering that infection rates have been on the rise over the last month

What does the US yield curve flattening signify?: Last week, we pointed out that US longer-end yields are moving more in sync with investors global growth expectations than US growth expectations. In this regard, the US 10-year yield has fallen further back to the levels that were seen in February-2021 as investors flock to the safety of US fixed income markets reflecting concerns about the global growth outlook. However, shorter-end US yields have not drifted lower by the same degree as investors are also simultaneously preparing for the Fed to move towards normalizing policy starting with a tapering announcement later in 2021.

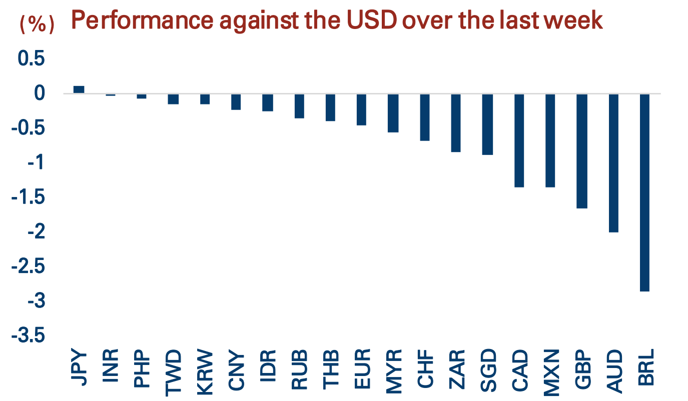
In theory, as longer-end yields drift towards shorter-end yields, it does provide a significant signaling device for investor expectations about the economic outlook. **We find a very strong historical positive correlation between global equity market movements and the shape of the US yield curve.** A steepening bias in the yield curve is accompanied by improving equity markets reflecting a favourable medium-term outlook. At the same time, a persistent flattening bias to inverted bias is accompanied by weakness in global equity markets reflecting concerns about the state of the economy.

Chart 1: Flattening US yield curve signals global growth concerns



Source: Bloomberg & ICICI Bank Research

Chart 2: The USD's rally has been broad-based



Source: Bloomberg & ICICI Bank Research

Over 2018, the US yield curve flattened and eventually inverted reflecting investor concerns about the outlook on back of the trade-war. Over 2H2020 in to 2021, the US yield curve has gradually steepened but that trend has reversed sharply over the last fortnight. Hence, an important question is on whether these concerns are justified at the current juncture and on whether it implies that the outlook has deteriorated sharply.

We are still maintaining our constructive outlook on global growth. We think that DM growth outlook remains favourable as so far none of the major economies have talked about re-introducing lockdowns or tightening restrictions as hospitalization rates have not increased by a sharp degree, even as infection rates appear to be on the rise. We see potential for considerable increase in private consumption in DM economies supported by expansionary policy over H22021 and in to H12022.

EM growth outlook in the near-term remains challenging as vaccination penetration remains modest. In most EM economies (Singapore, Indonesia, Thailand, South Korea), restrictions remain in place and mobility remains below the pre-COVID-19 levels. However, we see some improvement going in to Q42021 and in to Q12022 as vaccine penetration could improve allowing for a more broad-based opening of the economy than at the current juncture. Another important emerging concern is that private consumption in China has not picked up as sharply as was expected in H12021. Ongoing concerns about an increase in the geo-political tensions between the US along with its key allies and China is also working to weaken risk sentiment. In short, we think that appetite for EM assets in the near-term could remain fairly modest.

Whether yield curves provide a definitive indicator for growth cycles is much debated in academic circles. However, we see considerable lead and lags between the shape of the yield curve and the business cycle. While we acknowledge that near-term risk sentiment will remain challenged, we are not altering our expectations on the global economy over H22021 and H12022. We hold on to our view of a vaccine induced recovery led first by DMs then followed by EMs.

US assets: More support in store!

- The FOMC Chair's testimony to the House of Congress showed that the central bank might still want to see further progress before it moves forward on the tapering front. He reiterated his assessment that inflation pressures are likely to prove temporary, although he did acknowledge that the increase has been much faster than initial expectations. His comments make us believe that no significant changes are expected in the FOMC meeting due next week.
- Contrary to the comments made by the FOMC Chair, US CPI inflation showed a fairly spectacular broad-base rise in June to 5.4% YoY in June form 5% in May reflecting increases in both core and non-core elements respectively. There was also considerable evidence of a pick-up in consumer inflationary expectations that was visible in the release of New York Fed's survey of inflation expectations that jumped from to 4.8% that was the highest level recorded in the series so far.
- Economic indicators were mixed as US retail sales surprised to the upside increasing by 0.6% MoM in June against expectations of a contraction. However, the University of Michigan measure of consumer confidence fell quite sharply reflecting weak equity market performance and a rise in consumer inflationary expectations. However, 'hard economic indicators' are showing continued traction indicating that the recovery is moving in sync with expectations.

- We maintain our bullish call on the USD as investor concerns about growth prospects in the non-US world are expected to remain intact. Although the FOMC Chair has continued to provide a neutral message, we expect investors to continue to price in the central bank moving towards normalizing policy. We raise our range to 91.50-94.00 for the DXY and uptrend in the USD/EM pairs block.
- The US benchmark 10-year yield continues to drift lower that runs in sharp contrast to developments in the US economy. We maintain our view of an asymmetric pick-up in global demand for US treasury securities as investors rotate out of riskier assets in to safer assets. We lower our US 10-year sovereign yield forecast to 1.15%-1.30% in the near-term. We expect the shape of the yield curve to remain unchanged.

Domestic assets: Bearish bias could continue

- The main positive development was the softer than expected CPI inflation print that came in at 6.26% YoY in June from 6.30% in May easing concerns on the price front for the time being. At the same time, high frequency indicators have shown a continued improvement as the economy has re-opened and mobility has improved.
- The USD/INR pair has moved higher in sync with the deterioration in global risk sentiment. We raise our trading range for the near-term as investor concerns about EM growth prospects are expected to linger. We see a range of 74.00-75.50 in the near-term. However, INR could outperform other EM FX in the near-term given that restrictions are easing in the Indian economy while it has picked up in other regions such as Singapore, Indonesia, South Korea and Philippines.
- The INR 10-year yield moderated to 6.12% after touching a mid-week high of 6.135% mainly on the account of: (a) a sharp drop in oil prices to levels below USD 70/bbl (b) rise in risk aversion among investors amid concerns of delta variants (c) softening of the US yields as investors flee to safer assets and (d) strong growth in tax collection of the central government.
- Union government's tax collections in Q1 FY 2021 stood at INR 5.58 tn, registering a growth of 107% YoY. A stronger tax collection is likely to reduce the government's need for borrowing thereby reducing the supply of the bonds. Additionally, correction in Brent Crude oil prices reflecting an OPEC+ deal to increase the supply of crude by 400K barrels per day on an incremental basis every month over August-2021 to December-2022 will somewhat ease the inflationary pressures thereby providing additional room to the MPC before the August policy.
- RBI has announced next week's auction for the second leg of GSAP2.0 where it will buy bonds worth INR 200bn across maturities ranging from three to eight years. However, the new 10-year benchmark has been kept out of the auction as RBI focuses more on shorter-term securities. The market will closely watch for the results of the auction. We see a near-term range of 6.0% to 6.3% for the benchmark INR 10-year yield, as traders will respond to crude price movements, RBI's guidance on the GSAP programme and US bond yield movements.

EUR/USD: More downside potential is in store

- The main focus for investors will be on the ECB policy meeting. We expect the following:
    1. The ECB Governor has already indicated that the Central Bank will incorporate its revised monetary policy framework post the strategy review that concluded last week. The ECB is moving towards targeting a 2% symmetric inflation target from a previous CPI inflation target of around 2%. Hence, the forward guidance will likely have to change.
    2. The change in forward guidance is unlikely to imply a change in the policy framework at the current juncture but imply a much more accommodative regime in the medium-term.
    3. We expect no changes to be made to the policy rates, the open-ended monthly QE program and the PEPP program. Guidance on the PEPP will remain unchanged.
    4. Overall, we expect the ECB to provide a dovish guidance re-affirming that the need for accommodation remains firmly in place.
- We maintain our bearish outlook on the EUR/USD pair reflecting persistent global risk aversion. Investors will also likely respond to the PMI services indicator that will reveal whether momentum has slowed on the back of the rise of infections over June-July. We see a range of 1.17-1.20 for the EUR/USD pair.

GBP/USD pair: Under pressure from rising infections

- The rise in of infections is expected to continue to work as a bearish factor for the pair. Investors might ignore the improvement in retail sales figures and a high absolute level in PMI surveys.
- BoE officials have been sending mixed messages to investors. It appears that considerable divergence persists among members of the MPC. We expect the BoE to gradually move towards ending QE by end-2021 and maintain a neutral regime over 2022.
- We see a lower trading range of 1.35-1.38 for the GBP/USD pair.

USD/JPY: More downside potential is in store

- While USD has rallied uniformly against both DM and EM FX, the JPY has proven to be an exception. The safe-haven trade that has resulted in unwinding of JPY funded positions has worked to limit sharp upside bias emerging in the USD/JPY pair.
- As long as risk aversion remains dominant, we see the USD/JPY pair trading flat in the 108.50-110.50 range. The JPY could continue to appreciate against other non-USD currencies resulting in a trade-weighted appreciation.
- On the data front, the most significant release was Japanese CPI inflation that remained fairly muted. CPI inflation increased by 0.2% YoY in June while core CPI fell by -0.2% YoY reinforcing the fact that disinflationary forces remain in place. Hence, BoJ will continue with its accommodative stance ensuring that the JPY continues to trade as a funding currency in the near, medium and longer-term.

Emerging economies: Review of the main developments

- The slew of Chinese economic indicators confirmed that growth momentum is moderating. Chinese GDP slowed from 18% YoY in Q12021 to 7.9% in Q22021 reflecting weaker than expected private consumption and service sector activity over April-May. Trade flows and industrial sector continued to be the back-bone of growth in the region. High frequency indicators for June such as retail sales and industrial production came in line with expectations while the unemployment rate came in flat at 5% in June.
- After the required reserve ratio cut that was delivered by the People's Bank of China, the central bank has kept short-term money market rates unchanged and not infused further liquidity via its open market operation/liquidity windows.
- Bank of Korea (BoK) maintained status quo on expected lines but the decision was not unanimous as one member of the committee called for 25 bps rate hike. The statement further added that it will assess/ judge the need to adjust the degree of accommodation based on Covid-19 developments, economic outlook and financial risks. South Korea has led the economic rebound driven primarily by robust trade flows. Among the EM Asia central banks, the BoK could lead the normalization of policy with a possible 25 bps rate hike in Q42021.
- Fitch Ratings revised Philippines outlook to "negative" from "stable", citing the impact of the prolonged coronavirus pandemic but maintained its investment grade "BBB" credit rating for the Philippines. The downward revision reflects concerns about the structural hit that has taken place to public finances in the region.

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