NUS INVESTMENT SOCIETY

Global Macro Department –U.S. (OVERWEIGHT) Date: 15th December 2020

Analysts

Jeddy Yew Jin
Global Macro Analyst (Team Lead)
jeddyyewjin@u.nus.edu

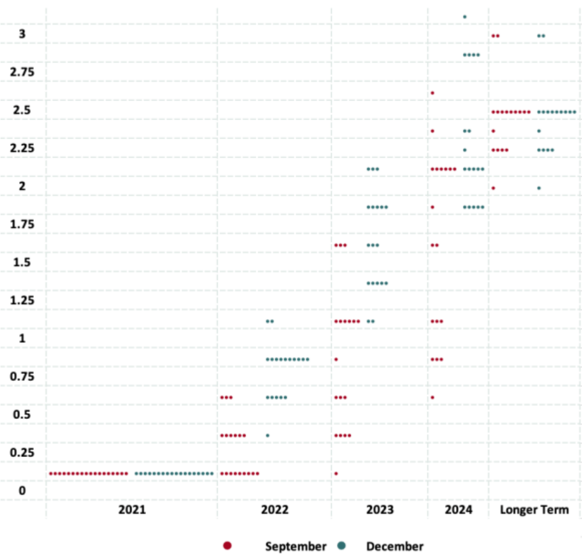
Nabil B Kamaludeen
Global Macro Analyst
nabil.k@u.nus.edu

Basic Information

Real GDP (USD)	20.94 trillion
M2 (USD)	21,187 billion
CPI	278.88
PPI	129.80
Con. Confidence	70.4
Stock Index	S&P500
Currency	USD

Chart info

Figure 1: Fed's Dot Pot (December 2021 Vs September 2021)



Source: FederalReserve.gov

Overview of the U.S. Economy

- GDP by sector: 0.9% Agriculture, 18.9% Industry, 80.2% Services
- GDP by component: 70% Personal Consumption Expenditure (PCE), 17% Business Investments, 18% Government Spending, 10.8% Exports, 14.7% Imports
- PCE/Consumer demand is the main driver in the U.S. economy
- USD is the currency most used in international transactions and is the world's foremost reserve currency
- The Federal Reserve System is the central banking system of the U.S., and sets the monetary policy to promote maximum employment and stable prices
- World's largest economy by nominal GDP of USD 20,807.2 billion in 2020, largest importers with USD 2,407.55 billion in 2020, Second largest exporters with USD 1,421.64 billion in 2020
- Main trading partners: China (10% exports, 18% imports), Canada (17% exports, 12% imports), Mexico (16% exports, 14% imports)

Summary of events in the past 6 months

<u>June 2021 FOMC meeting</u>

- set the interest rate paid on required and excess reserve balances at 0.15% (0.10% since March 2020)

<u>July 2021 FOMC meeting</u>

- Committee to continue its USD 120b QE program "until substantial further progress has been made" (repeated since Dec 2020 when it started)
- "Since then, the economy has made progress toward these goals, and the Committee will continue to assess progress in coming meetings"

<u>August 2021 Jackson Hole Meeting</u>

- "If the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year"

<u>September 2021 FOMC meeting</u>

- Fed Dot plot: 9/18 FOMC members projecting rate hikes in 2022, compared to 7/18 in June 2021
- When talking about the USD 120b QE program: "Since then, the economy has made progress toward these goals. If progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted."

<u>Congress raises debt ceiling in October 2021</u>

- In October, congress voted to raise the debt ceiling by $480 billion – enough to fund the treasury until mid-December. Congress will meet again to discuss the raising of the U.S. debt ceiling before 15th December 2021, the date when the treasury is expected to run out of cash to pay its bills which would result in a default

<u>November 2021 Bills Passed</u>

- Infrastructure Investment and Jobs Act (IIJA) is passed by the House on the 5th November
- President Biden signs the IIJA on 15th November
- Build Back Better Act (BBBA) is passed by the House on 17th November and heads to the Senate for voting in December

<u>November 2021 FOMC meeting</u>

- When talking about inflation: "Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors"
- Announced start of tapering by USD 10b for Treasury securities and USD 5b for mortgage-backed securities, starting in November 2021 and December 2021
- Judges that similar reductions will likely be appropriate each subsequent month, but is prepared to adjust the pace if warranted by changes in economic outlook

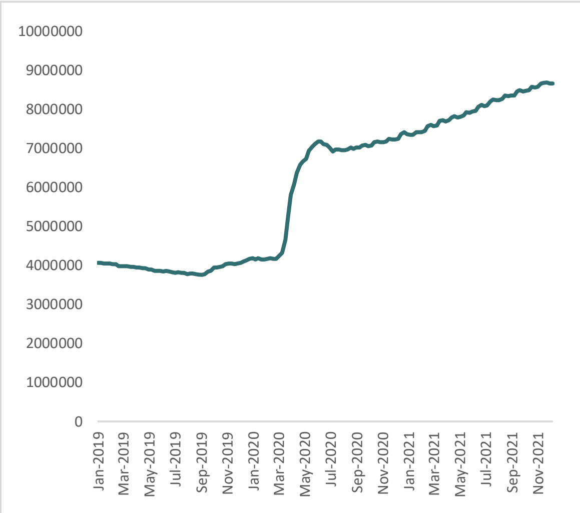
<u>December 2021 FOMC meeting</u>

- When talking about inflation, removed sentence "Inflation is elevated, largely reflecting factors that are expected to be transitory."
- Doubled the pace of tapering to USD 20b for Treasury securities and USD 5b for mortgage-backed securities
- Fed Dot Plot: Brought forward expectations of rate hikes to 3 in 2022, 3 in 2023, and 2 in 2024

<u>Omicron Variant (26th November 2021)</u>

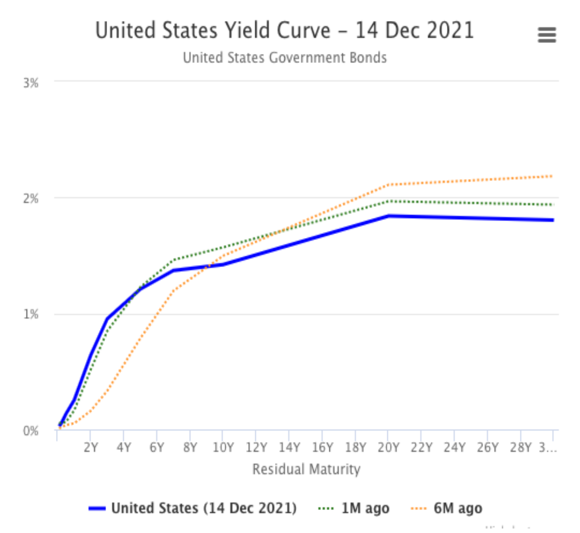
- Risk off market sentiment by the news that a new Covid variant is spreading in Southern Africa
- JPY and CHF was preferred over USD as safe-haven currencies

Figure 2: Fed's Balance Sheet



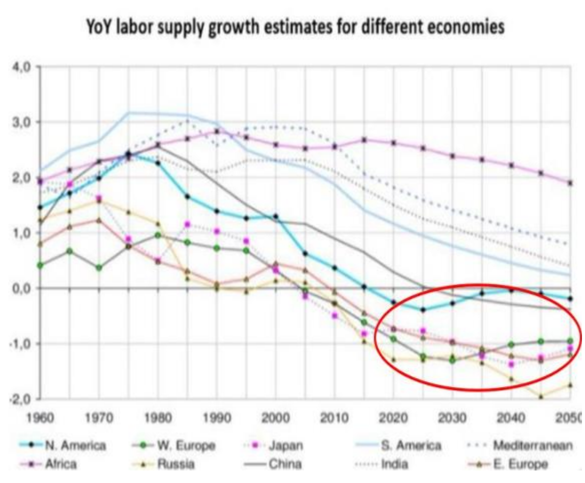
Source: FederalReserve.gov

Figure 3: U.S. Yield Curve (CAA 14th December 2021)



Source: worldgovernmentbonds.com

Figure 4: U.S. Labour Supply YoY Growth



Source: themacrocompass.substack.com

Monetary Policy: Feds Walking A "Tight-ening" Rope

Since end-2019 when the Covid-19 virus disrupted global economies, the Feds have cut interest rates to effectively zero (0.0-0.25%) and launched a massive quantitative easing (QE) program: (1) a USD 700b QE program announced in Mar 2020, (2) and the continuation of USD 120b of asset purchases per month since Dec 2020. Over USD 4t has been added to the Fed's balance sheet, more than doubling pre-pandemic levels and currently standing at over USD 8.6t.

When analysing the Feds decisions, it is important to first know that the Feds have a dual mandate of maximum employment and price stability, which are the 2 main factors to look at. Just to recap, for price stability, the Feds have adopted a new framework in Aug 2020 called flexible average inflation targeting (FAIT), where they would allow inflation to run "moderately" above the 2% goal "for some time" following periods when it has run below that objective.

For where the 2 goals stand now, as of Nov 2021, employment is still ~ 4 million jobs below pre-pandemic levels, and core inflation has been running over more than twice the objective (of 2%) for 5 consecutive months.

During the Nov 2021 FOMC meeting, the Fed announced the commencement of the tapering off its quantitative easing program of USD 80b of treasury securities and USD 40b of mortgage-backed securities, by USD 10b and USD 5b respectively in Nov and Dec, and left subsequent amounts in 2022 to be confirmed with incoming data. Powell has also been communicating that rates lift off would only happen AFTER tapering has ended. Markets had priced in 2-3 rate hikes of 0.25bps each by the end of Dec 2022, starting from right after the tapering has ended in June 2022 (if the taper timeline is left unchanged). The Feds have communicated at that time that they expect supply chain bottlenecks to ease going into 2022, which continues to tie in with their "transitory" narrative. Whether this plays out or not, the tapering timeline does gives the Feds a buffer period to balance between high inflation (and whether it's transitory) and a still-not-fully recovered labour market, on whether to pull back on its accommodative policies.

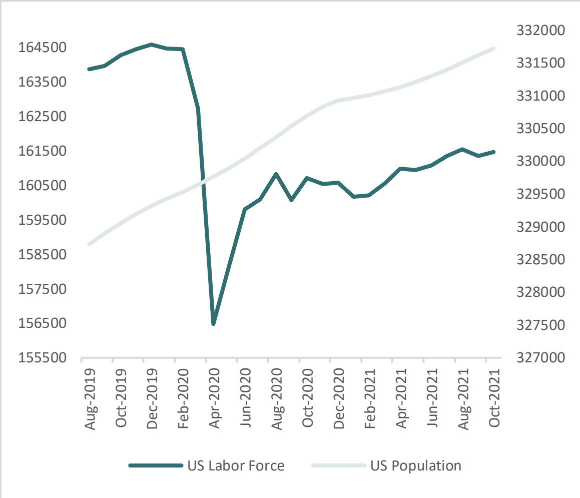
At the time of writing, U.S. treasury yield curves have been flattening as seen in Fig. 3, which shows a pull forward of expectations of short term rate hikes (short end) as well as declining future growth expectations (long end). This was due to unrelenting high inflation data in recent months along with Powell retiring the use of the word "transitory" inflation, which will be further discussed below.

<u>Labour Supply: A Look At The Cake Too, Rather Than Just The Slice</u>

When looking at unemployment rates, many a times we tend to just focus on the no. of people unemployed (slice of the cake/numerator) rather than the labour supply (cake/denominator). Sometimes, the cake also tells a story. The deteriorating labour supply in the U.S. has been becoming something increasingly alarming we have to look at.

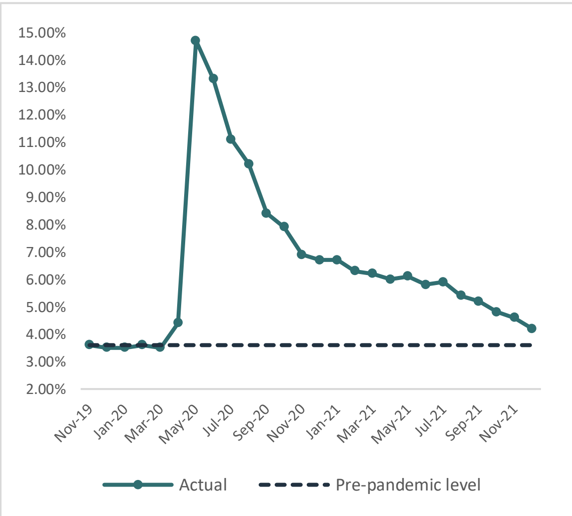
OECD also estimated YoY labour supply growth to be negative for all developed economies over the coming years, as seen in Fig. 4. Oct 2021's jobs data on labour supply still remains a concern, with labour force (those working or actively looking for work) rising by a muted

Figure 5: U.S. Labour Supply Vs Population (in '000s)



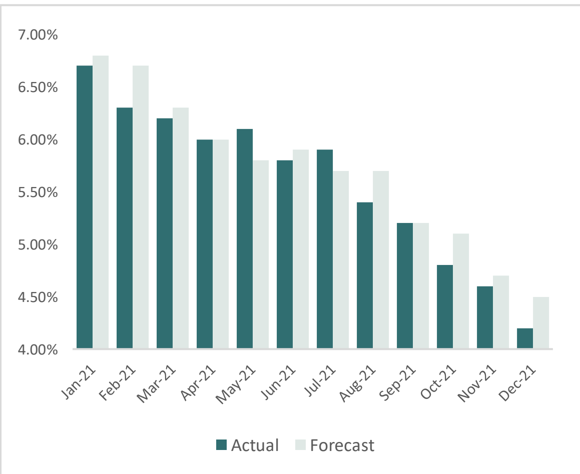
Source: Bureau of Labour Statistics (BLS), Federal Reserve Economic Data (FRED)

Figure 6: U.S. Unemployment Rate



Source: Investing.com

Figure 7: U.S. Unemployment Rate (vs 2021 forecasts)



Source: Investing.com

104,000, not enough to keep pace with population growth. With labour supply expected to decrease in the coming years, along with how the pandemic has affected millions of workers, the denominator of unemployment rate (labour supply) faces even more pressure, along with the overall health of the U.S. labour market. Nov 2021's data on labour force rose by 594,000, which is a good sign, but we would have to see how it plays out in the upcoming months.

Over the past couple of months, although there has been a bettering of the unemployment rate, this has been paired with bad nonfarm payrolls numbers (change in no. of people employed i.e. jobs created), as seen in Fig. 6-8. Of the last 4 months (since Dec 2021), nonfarm payrolls have missed expectations 3 times, but unemployment rate has either hit or was better than expectations. This again points to risks of a weakening labour supply growth, as this shows the denominator of unemployment (labour supply) underperforming, since the numerator of unemployment missed expectations (labour demand i.e. nonfarm payrolls) but unemployment was still overall better.

A weaker than expected nonfarm payrolls also indicates weak growth. Along with rising wages (average hourly earnings MoM has came in stronger than expected for the past 5/8 months since May 2021, Fig. 9), and inflation seeming structurally higher (Fig. 10-11), stagflation (low growth and high inflation) risks cannot be ignored.

The labour market disconnect has been blamed on caregiving needs during the pandemic, fears of contracting the coronavirus, early retirements, massive savings and career changes as well as an aging population.

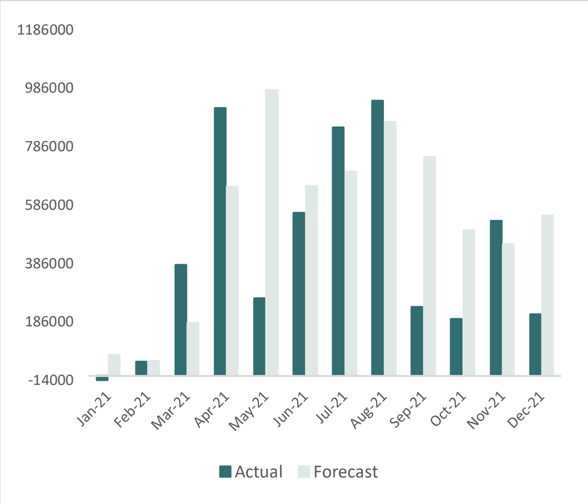
The most recent emergence of the Omicron variant in end Nov 2021 could also possibly deter the Feds from quickening its taper timeline and raising of rates thereafter. At the time of writing, health officials are still trying to determine how transmissible and deadly the variant is and to what extent current vaccines remain protective. Should it prove to be more deadly than the Delta variant, the Feds would have to consider how it would affect the labour market, which remains a key metric when deciding when they should pull back its accommodative policies.

<u>"Transitory" To Be Removed From The Fed's Vocabulary</u>

November 2021 inflation data that came out a week after the November 2021 FOMC meeting continued to come in higher than expectations (Core CPI YoY 4.6% vs 4.3% expected, Core CPI MoM 0.6% vs 0.4 expected). This prompted Powell, on his 29th Nov 2021 testimony before the Senate Banking Committee, to turn slightly hawkish, and communicated that it would be appropriate to end the tapering "a few months sooner", which Powell expects to be discussed in the Dec 2021 FOMC meeting, due to a strengthening economy and significant inflationary pressures. Markets were risk-off, and the testimony by Powell added worries to already bearish markets over the emergent Omicron strain of Covid-19 just a few days before.

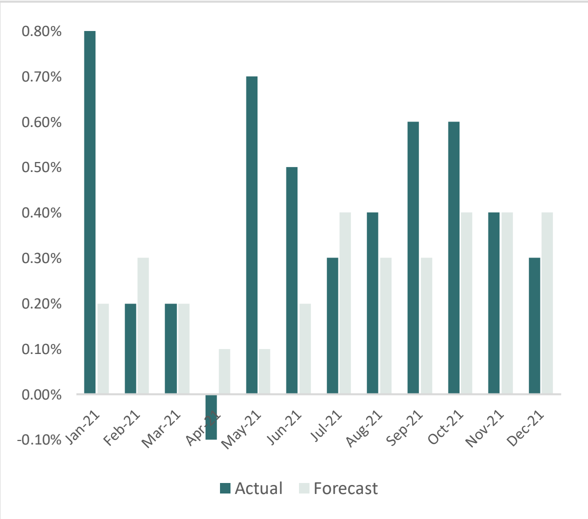
The Feds are finally acknowledging that inflation might not be so "transitory", a term that Powell has been using throughout 2021 to convey the expectation that it was rooted in factors like pandemic-related supply-chain kinks rather than those that would lead the rapid pace of price increases to become entrenched. This paves the way for

Figure 8: U.S. Nonfarm Payrolls



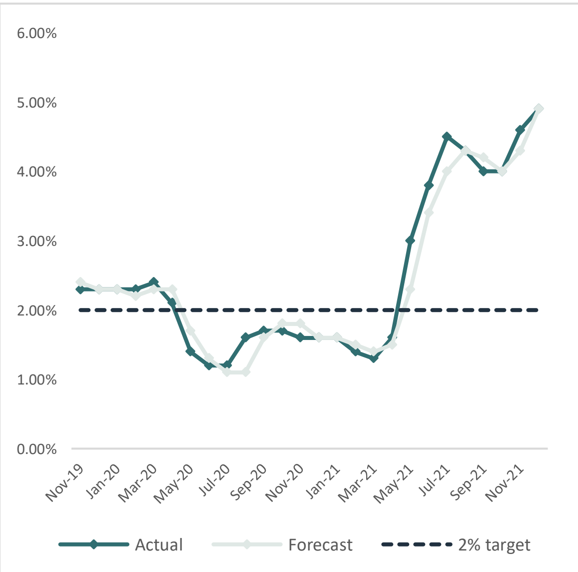
Source: Investing.com

Figure 9: U.S. Average Hourly Earnings MoM



Source: Investing.com

Figure 10: U.S. Core CPI YoY



Source: Investing.com

a more hawkish stance going into 2022, where the Feds won't be relying on the excuse of pandemic-related factors affecting inflation.

Powell has seemed to tip the balancing scale of policy tightening towards fighting off the structurally higher "not-transitory" inflation, and seems optimistic on the labour market. However, we are of the view that the labour market is still far from fully recovered (at least further than what the Feds seem to view it as), especially with never-ending virus variants emerging, which potentially disrupts labour recovery. We are also of the same view as the Feds that inflation is no longer transitory and has turned secular. Rent makes up the biggest component in CPI, and is arguably the most sticky. As seen in Fig. 12, owner's equivalent rent (OER) YoY is reaching multi-year highs, which suggests inflationary pressures are beginning to broaden out beyond areas related to pandemic shocks. Other than rent, the excessive fiscal stimulus in 2020 and 2021 to support the economy from the pandemic (which amounted to approximately USD 5 trillion), along with rising wages (Fig. 8) which can lead to a wage-price spiral, would head inflation away from being "transitory" to permanent.

Although the faster taper and rates lift off timeline is essential in battling against the higher inflation, this could also prove harmful to the labour market, maybe even forcing the Feds to revert their decision in the future should this play out, pointing towards some correction in the Dollar should it be overvalued in the short to medium term.

Fiscal Policy: An Uphill Battle in The Capitol

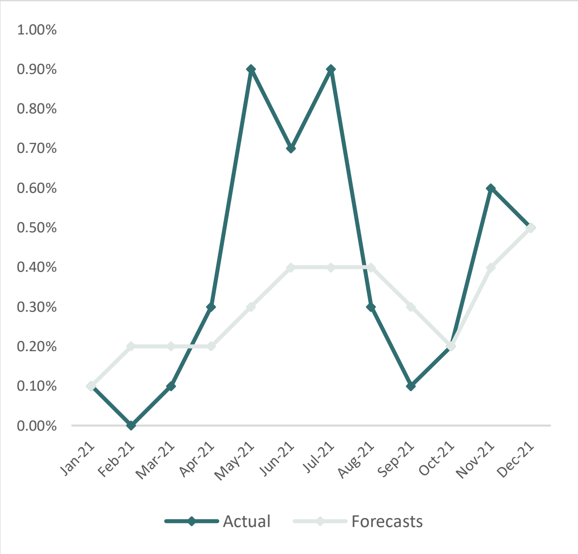
Raising the Debt Ceiling

Republicans have vehemently opposed Democrats spending bills for months, labelling them "the single most reckless and irresponsible spending bill in the nation's history". The Republicans blame the Democrats for the ever-rising national debt while the Democrats argue that it is a shared responsibility of both the Democrats and Republicans. The national debt grew by 7.8 trillion (fig. 12), or by 33% during the Trump administration as a result of tax cuts and covid-19 spending. Biden's fiscal policies will only contribute to an additional 3% of the existing debt. Furthermore, raising the debt ceiling is about meeting current obligations rather than funding new debt. The squabble comes about as President Biden and the Democrats try to pass the Infrastructure Investment and Jobs Act (IIJA) and Build Back Better Act (BBBA), both amounting to nearly $3 trillion.

In October, lawmakers reached an eleventh-hour agreement to raise the debt ceiling by $480 billion to $28.9 trillion, essentially giving Washington the power to borrow into early December. The US government spends more than it collects, thus the need to borrow. Borrowing is done via the US treasury, by issuing bonds. The debt ceiling determines how much the government debt the government can borrow. Historically, the ceiling has been lifted more than 100 times to allow the government to borrow more and is seldom the subject of a political standoff. However, as the country has been increasingly partisan, lawmakers have used the debt ceiling vote as leverage against other issues.

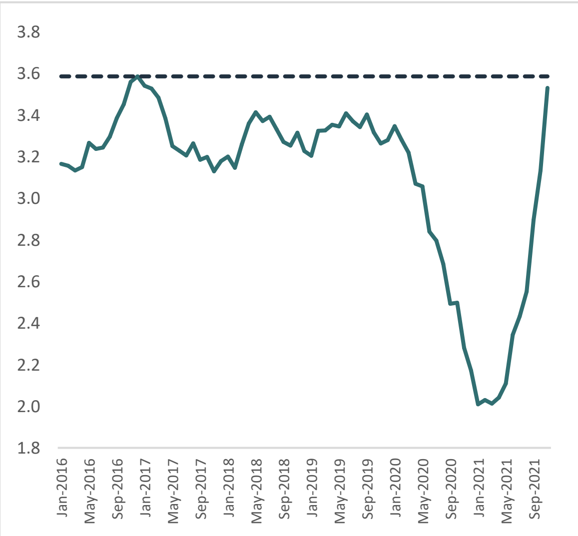
The agreement came after weeks of political brinkmanship driven mainly by Republicans, who initially refused to supply their must-have votes in the Senate as part of their efforts to undermine Biden's

Figure 11: U.S. Core CPI MoM



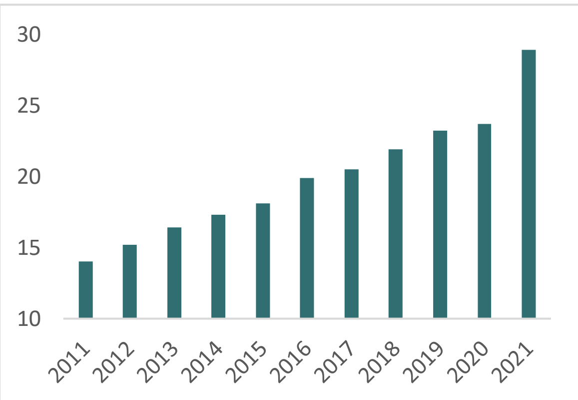
Source: Investing.com

Figure 12: Owner's Equivalent Rent (OER) of Residences in U.S. City Average YoY



Source: FRED

Figure 13: Federal Government Debt (in trillions)



Source: tradingeconomics.com

economic agenda. Exiting that battle, Senate Minority Leader Mitch McConnell assured congress that Republicans would not support another increase. He instead demanded that Democrats address the debt ceiling on their own using a process called reconciliation.

Without the agreement to raise the debt ceiling, the US would have defaulted on its debt for the first time in history. An event of that magnitude would have triggered a massive financial crisis and ruined America's creditworthiness, undermining the global faith in American markets. The government would have to immediately stop more than 40% of expected payments. This includes interest payments to its bondholders and payments to important programs like Social Security, Medicare, Medicaid and defence. This would have a knock-on effect on the whole economy. For a start, the country's credit rating would automatically get downgraded, driving up interest rates for Americans.

The fiasco further added to tensions between Democrats and Republicans in both the house and senate especially when it came to the voting of the Infrastructure Investment and Jobs Act (IIJA) and Build Back Better Act (BBBA). President Biden condemned the actions of the Republicans, saying it amounts to "playing Russian Roulette with the economy" and "hypocritical, dangerous and distasteful".

The decision to raise the debt ceiling by $480 billion allows the US government to pay bills up to early to mid-December. Congress will have to vote again in December to avoid a default. Another round of clashes is likely to take place as McConnell wrote to Biden shortly after the agreement in October was made that he would "not provide such assistance again" and that the Democrats should resolve the issue themselves (through reconciliation). It will be another case of who flinches first - neither party would want to be at fault if or when the government defaults on its obligations, sending markets into a turmoil.

While the Democrats and Congress have ways to circumvent a default, the mere thought of a U.S. default is enough to send the market into a frenzy. In 2011, the U.S. were a few days away from a default as Republicans blocked an increase in the debt ceiling to coerce Democratic President then, Barack Obama, to make concessions to his spending plans. After the market closed on Friday, S&P downgraded the U.S. credit rating from AAA to AA+ following the political squabble between both parties. When markets opened on Monday, the S&P 500 tumbled 6.6%.

<u>Infrastructure Investment and Jobs Act ($1.2 trillion)</u>

Originally known as the Bipartisan Infrastructure deal or INVEST in America Act, it was initially a $715 billion infrastructure package but after congressional negotiations, it was amended and renamed to the Infrastructure Investment and Jobs Act (IIJA) which includes funding for broadband access, clean water, electric grid renewal in addition to the transportation and road proposals of the original bill.

The bill was passed by the Senate on 10th August 2021 with a 69-30 vote. The House of Representatives passed the $1.2 trillion IIJA by a 228-206 vote on 5th November 2021. 13 Republicans and all but 6 of the House of Democrats voted for the bill. The bill was signed by President Biden 15th November.

Figure 14: Timeline of Issues at Capitol Hill

Issue	Date
IIJA passed by Senate	10th August
Debt ceiling is raised until December	12th October
IIJA passed by House	5th November
President Biden signs IIJA	15th November
BBBA passed by House	17th November
BBBA heads to Senate for voting / amendments	December
Congress decision to raise debt ceiling	December

Source: Reuters, CNBC, Bloomberg

Progressives had threatened to vote against the measure but, at the last minute, agreed to support it after moderates promised they would back the companion social safety net and climate bill, officially known as the Build Back Better Act (BBBA)—provided an upcoming cost score by the Congressional Budget Office (CBO) showed that the plan would not add to the budget deficit.

The legislation seeks to address a broad range of critical needs in the United States' built environment, which was recently rated C-minus by the American Society of Civil Engineers. The act will modernize the country's aging infrastructure through extensive upgrades for roads and bridges. The IIJA further provides funding to replace lead pipes that provide drinking water and to remediate pollution in disadvantaged communities—thus helping to build a more inclusive and sustainable economy. The act allocates $1.2 trillion over 10 years, including $550 is new spending, divided between improving the surface-transportation network ($284 billion) and enhancing core infrastructure ($266 billion)

Biden's Build Back Better Act (USD 1.75 trillion)

The House passed the BBBA on 17th November 2021, by a vote of 220-213, mostly along party lines with the exception of one democrat voting against it. The BBBA finally passed after months of starts and stops. The bill is now on its way to the Senate for passing. Senate Majority Leader, Chuck Schumer (Democrats) will need all 50 members to back the bill. It is expected that the Senate will make amendments to the paid leave program and tax policy. Any changes made to the package will be sent back to the House for reconsideration.

The bill, which was proposed to be $3.5 trillion initially, was brought down to $1.75 trillion after Democratic leaders spent weeks of intraparty negotiations primarily between moderate Democratic Senators, Joe Manchin and Krysten Sinema and the progressives in the House. The Moderates and Progressives agreed on the goals of the bill but were divided over the size of the bill and how it should be funded. The reduction in the bill size was inevitable as all Democrats' votes were needed to pass the bill. Furthermore, the Democrats would not allow their President's plan to fail especially with the midterm elections in 2022.

The package is unlikely to contribute a significant amount to the deficit after accounting for revenue that will be generated through the Democrat's plan to beef up Internal Revenue Service (IRS) enforcement to go after wealthy tax evaders.

The bill consists of 7 significant provisions. (1) Fighting climate change ($550 billion). This is in line with Biden's goal of halving carbon emissions by 2030. (2) free universal preschool for all three- and four-year-olds ($400 billion). (3) Child tax credits ($200 billion). The bill grants a one-year extension of the pandemic-era child tax credit, which provides parents with $300 every month per child under age six and $250 every month per child ages six to 17. Families that do not earn enough money to qualify for income tax liability will be eligible to continue receiving the full child tax credit beyond the one-year period. (4) Four weeks of unpaid leave ($200 billion). The bill creates a permanent national paid leave program that gives both employed and self-employed workers four weeks of paid family and medical leave, which can be used for caregiving or personal illness. Workers who request paid leave would be granted up to 90% of their income depending on their salary. (5) Healthcare spending ($165 billion). The bill reduces healthcare premiums under the Affordable Care Act and expands Medicare coverage to include hearing benefits. (6) Affordable home care ($150 billion). The plan provides funding for a Medicaid program that supports in-home health care. (7) Affordable housing ($150 billion). The bill aims to reduce cost pressures by providing rental and down payment assistance through an expanded voucher program

Democrats claim that the BBBA package will be funded for by tax increases on the wealthy and corporations, but the CBO found that this will only raise around $1.5 trillion over 10 years, just $250 billion short of the proposed $1.75 trillion figure. It is expected that the BBBA is likely to increase the federal budget deficit by $160 billion over the next 10 years. However, the White House still maintains that it is possible for the BBBA to be fully paid for without increasing the deficit.

We are of the view that the IIJA and BBBA are unlikely to affect the markets in the short to medium term. Both the packages are not considered stimulus packages and are not a singular response to a specific economic crisis. Rather, both packages represent a longer-term patient approach to rebuilding American competitiveness through infrastructure. In the long-term, the IIJA is expected to ease inflationary pressures and strengthen supply chains by making improvements to ports, airports, rail and roads. The IIJA and the BBBA will add an average of 1.5 million jobs per year for the next 10 years. The two bills will create millions of well-paying jobs, improve supply chain networks, make long overdue improvements to infrastructure, meet climate goals and expand the nation's social safety net – all which are crucial to the nation's economy in the long-run. We view this as prudent spending that will boost American productivity and GDP in the long run.

<u>Congress' Christmas To-Do List</u>

While the country celebrates the holiday season, Congress will have a busy December – mainly preventing a government shutdown and passing the BBBA before Christmas. Talks between Schumer and McConnell have been progressing positively with both parties looking like they will achieve a bipartisan solution to address the debt limit, thus avoiding a government shutdown. The Republican leader seemed to have changed his stance from the October meeting, from being uncooperative to being collaborative. Both Democrats and Republican leaders in the senate voiced their confidence on 30th November that both parties are likely to pass legislation to raise the federal government's $28.9 trillion debt limit. This cooperation is likely due to the looming midterm elections in late 2022, where neither party would want to be at fault for a government default and shut down.

Figure 15: 4H chart of USDCAD

Source: Tradingview

Figure 16: Daily Chart of USDCAD vs US02Y-CA02Y (US CAD 2Y Yield Differential)

Source: Tradingview

Figure 17: Daily Chart of USDCAD vs BRN2! (Brent Crude Oil Futures, Continuous: Next Contract In Front) inverted

Source: Tradingview

Trade Idea: Short USDCAD

<u>Narrative</u>

We would like to pitch a tactical short on the USDCAD as we see some potential downside in the short term. While we remain firmly bullish on the USD in the medium to long term due to a strong economic recovery (compared to other developed countries) and a tightening Fed, we believe the recent rally in the USDCAD is overdone mainly due to a combination of factors: (1) high U.S. inflation data in recent months leading to taper timeline/expectations of rates lift off being pulled forward, (2) renomination of Fed Char Powell, (3) Omicron variant fears leading to a preference of USD as a safe haven over CAD, (4) and a sharp drop in crude oil prices due to Omicron fears weakening the CAD.

<u>Catalysts</u>

Should Omicron variant fears subside in the short term and demand surges back (with supply still limited amid a plethora of geopolitical reasons), a continued rise in oil prices would give strength to the CAD. A rise in oil prices would benefit CAD more over USD as oil exports contributes to ~10% of Canada's GDP compared to ~8% of U.S.'s GDP. The CAD has also been highly correlated with Brent Crude Oil prices, as seen in Fig. 17.

Besides, Canada's labour market recovery continues to outpace the U.S., with its labour market fully recovered to pre-pandemic levels compared to U.S. with ~4 million jobs still lost. We continue to view that the Bank of Canada (BoC) will continue to be ahead of the Feds in terms of raising rates, which would support the CAD.

A point also worth taking note of is that the FOMC will have 4 hawks leaving by Dec 2022, 2 of which left prematurely, Rosengren (Boston Fed) and Kaplan (Dallas Fed), due to controversy on them breaking trading regulations, and 2 board of governors that will retire (Quarles and Clarida). This move would be net dovish. Although we still view inflation to be the main driver on how Central Banks will change monetary policy, this is still something worth taking note of.

Technicals

Historically, USDCAD has been highly correlated to the US CAD 2Y yield differential. Due to recent bullish run (explained above) of USDCAD, a divergence has been formed between USDCAD and US02Y-CA02Y, as seen in Fig. 16. This leads us to believe for some potential for a bearish USDCAD in the near term.

In our 4H chart as seen in Fig. 15, we would enter at 1.2786 (just below the resistance zone), place our stop loss at 1.2850 (previous high), and place our take profit at 1.2607 (right above the 0.382 Fibonacci level, and at the previous low).

Some risks to take note of is the ascending triangle pattern forming (in yellow), which might signal a very strong breakout upwards in the USDCAD. We believe in the very short term any bearish movement in the pair would be the last few bearish moves before the ascending triangle pattern fully forms and breaks out upwards (aligning with our long term bullish USD view).

Entry: 1.2786
Take Profit: 1.2607
Stop Loss: 1.2850
Risk Reward Ratio: 2.79

NUS INVESTMENT SOCIETY

Global Macro Department – Mexico (UNDERWEIGHT) Date: 15th December 2020

Analysts

Jeddy Yew Jin
Global Macro Analyst (Team Lead)
jeddyyewjin@u.nus.edu

Nabil B Kamaludeen
Global Macro Analyst
nabil.k@u.nus.edu

Basic Information

Real GDP (USD)	1.076 trillion
M2 (USD)	518 billion
CPI	115.56
PPI	113.00
Con. Confidence	45.8
Stock Index	MEXBOL
Currency	MXN

Chart info

Overview of Mexico's Economy

- Mexico is the 15th largest economy in the world and second largest in Latin America by nominal GDP ($1.19 trillion)
- Mexico is an export-oriented economy and is highly dependent on the US as its main trading partner. The US accounts for 83% of Mexico's exports and 46% of Mexico's imports
- Mexico's economy suffered heavily in 2020 with its real GDP contracting 8.3% but is poised to grow by an estimated 5.4% in 2021, primarily fuelled by exports

Summary of events in the past 6 months

Inflation shows no sign of abating

- Mexico's inflation reached a 20-year high of 7.05% in November
- Banco de Mexico (Banxico) raised interest rates by 25 basis points for the fourth time this year to 5% in November
- Banxico is expected to raise rates again by another 25 basis points in December
- USDMXN has been relatively stable throughout the year, trading between 19.5-21.25 despite Banxico raising interest rates several times
- Banxico only expects to meet its inflation target of 3% in 2023
- ALMO picks new central bank governor, Deputy Finance Minister Victoria Rodriguez raising questions regarding Banxico's autonomy

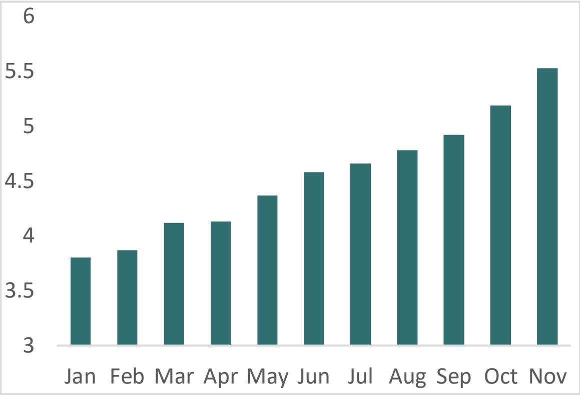
Recovery slows down due to the delta variant

- Banxico had reduced its GDP growth forecast to 5.4% down from 6% for 2021 due to persistent supply chain bottlenecks and shutdowns caused by the Delta variant
- Mexico's GDP contracted 0.4% in Q3 after 4 consecutive quarters of positive growth

AMLO delivers a new constitutional reform for the Electric Industry Law

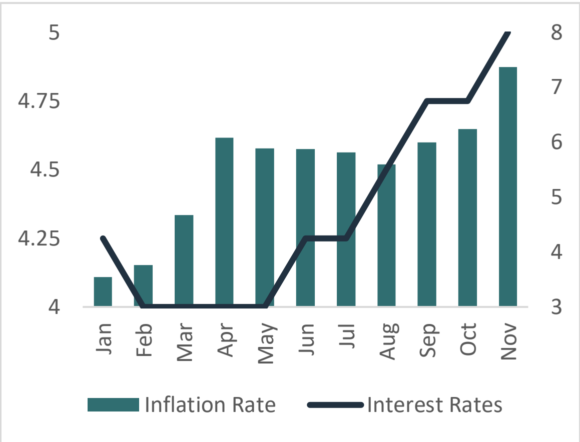
- If approved, the reform would give the CFE ~56% of the electricity market and put it in charge of setting terms for private generators

Figure 1: Mexico's Core Inflation



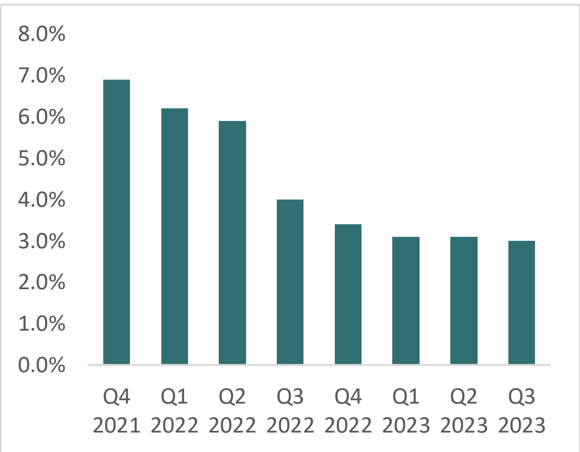
Source: tradingeconomics.com

Figure 2: Inflation and Interest Rates



Source: tradingeconomics.com

Figure 3: Banxico Inflation Forecast



Source: Banco de Mexico, Bloomberg

Mexico's Sluggish Recovery

It is no secret that Mexico's' economy has been underperforming for nearly two decades; Mexico's average annual growth rate for the past 25 years has been 2.3%, a relatively low figure compared to the global average of 3%. Clearly not good enough for an emerging economy. The Mexican economy is rebounding from its deepest recession in decades, driven by strong U.S. growth and the pandemic-related re-opening of sectors. After shrinking 8.3% in 2020, real GDP is forecast to grow by 5.4%, in 2021 and 4% in 2022 albeit still far from returning to pre-pandemic levels. Banxico had actually lowered its projected GDP growth expectations to 5.4% down from 6.2% in late December, amidst new pandemic containment measures and persistent supply chain bottlenecks.

The Mexican economy contracted 0.4% in Q3 2021 (Fig. 5), above preliminary estimates of a 0.2% decrease. It is the first contraction in four quarters, derailing their recovery. The service sector which shrank 0.9% in Q3 was a major contributor to the contraction in the third quarter. Services were hindered by the rise of the delta variant of the coronavirus during Q3, resulting in shutdowns and restrictions for restaurants, stores, and other public venues. Services were also affected by the new law passed in April banning most subcontracting (with the exception of specialised labour) in an effort to fight tax evasion and ensure employee cover benefits - part of Mexico's long-term effort to bring more citizens into the formal economy. The contraction helped dissuade Banxico from a more aggressive rate hike.

On one hand, inflation has significantly exceeded its target for several months, raising concerns that higher inflation could become deeply entrenched, with potential second-round effects on wage-price spiral. In this context, tightening monetary policy could provide security against more long-lasting increases in prices and help anchor inflation expectations more firmly. While this would come as costs in the form of foregone output and employment, these may be relatively modest compared to the economic costs that would need to be incurred to re-anchor inflation expectations if they started to move upwards.

Monetary Policy: Rate Hikes, But Inflation Climbs Faster

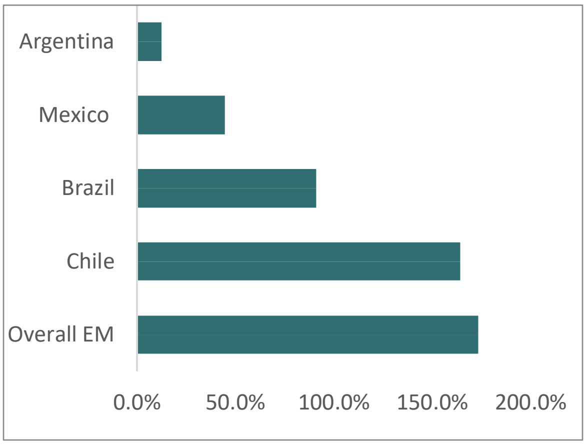
How Effective is Banxico's Monetary Policy?

Inflation in Mexico is surging way beyond the central bank's target of 3% (plus minus 1%) and it only expects to hit that target in early or mid-2023. Consumer price inflation rose to 7.05% in November 2021, the highest 12-month rate since April 2001. Core inflation, which excludes volatile items such as fuel, was 5.53% as of November 2021 and showed no signs of abating.

On 11th November 2021, Banxico raised interest rates by 25 basis points for the fourth consecutive policy meeting to 5%. The decision comes as inflation showed no signs of cooling in September and October despite raising interest rates in May, July and August as seen in Fig. 2.

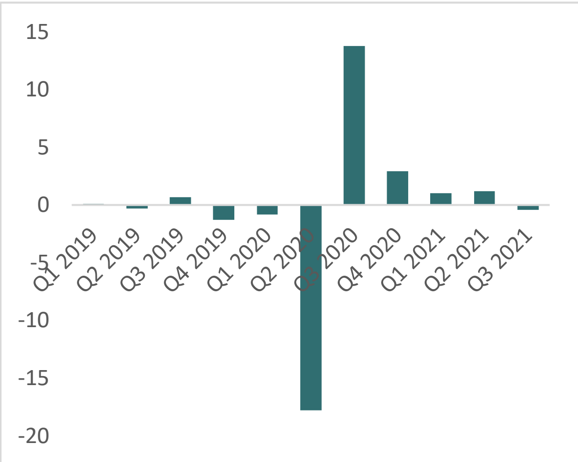
Mexico's high inflation is largely attributed to pandemic related disruptions to supply chains, rising commodity prices and the heating of the US economy - things which are beyond the control of the central

Figure 4: Credit to Households/Businesses as a share of GDP



Source: Bloomberg

Figure 5: Mexico's GDP Growth



Source: tradingeconomics.com

bank. Additionally, costlier domestic goods and services such as airfares amid the reopening of the Mexican economy further contributed to the rising prices.

On 1st December 2021, Banxico raised its inflation forecast and lowered its growth expectations for the year saying that the balance of risk for inflation was biased to the upside while the balance of risk for growth was biased to the downside. Both attributed to the prolonged pandemic situation and the emergence of new variants as well as 'unexpectedly' persistent supply chain bottlenecks and higher input costs. Mexico's updated inflation forecast comes at a time where inflation is proving to be stickier than expected with the U.S. Federal Reserve Chairman ditching the word 'transitory' and the European Central Bank (ECB) as well as the Bank of England (BoE) increasing their upside risk on the inflation outlook

As for inflation forecasts, Banxico sees inflation starting to subside in early 2022 and inflation to reach its 3% target sometime in 2023(Fig. 3). This is of course in the case that pandemic related bottlenecks start to ease soon - which is looking less and less likely with the new Omicron variant making its rounds globally. Longer-than-expected supply shocks will likely result in further rate hikes in 2022. Despite Banxico's relatively more hawkish stance compared to the U.S. Feds, USDMXN seems largely unaffected with the pair trading between the 19.5-22 range. This reflects investor's tendency to stick to safe haven currencies like the USD amidst the uncertainty of the global economic outlook.

We view that raising interest rates have little impact on countering inflation and this is largely due to the country's large informal economy. Less than 40% of Mexicans have access to bank accounts compared to the 55% figure for Latin America. Essentially, Mexicans are under-banked. There is relatively little lending in Mexico and credit to households and businesses only adds up to 45% of Mexico's GDP - a relatively low figure when compared to its peers like Brazil (91%) and Chile (164%) as seen in Fig. 4. Hence, adjusting key rates and increasing the cost of credit have little impact on reducing demand. It is also worthy to note that Mexico stands out for its fiscal discipline than in most countries (AMLO did not approve of any major stimulus packages due to his preference for fiscal austerity), which has relieved pressures on the sovereign risk premium and the exchange rate. This should allow Banxico to implement a less restrictive monetary policy, which has not been the case.

On the other hand, raising rates does however attract foreign investors, propping up the currency, making imports cheaper for Mexico. It also makes Mexico's exports less competitive putting policy makers in a tight spot as Mexico is an export-oriented economy.

However, we are still of the view that many of their problems such as poverty, corruption, tax evasion and a large informal economy are deeply rooted and existed pre-pandemic. The pandemic hit regions like Mexico the hardest, further exacerbating these issues leaving policy makers walking an especially precarious line.

Electricity Reforms Continue To Supercharge Mexico's Markets – In A Bad Way

Just a recap from our previous report, President Andrés Manuel López Obrador (AMLO) had previously signed into law the Decree that Reforms and Adds Diverse Provisions to the Electric Industry Law (*Decreto por el que se reforman y adicionan diversas disposiciones de la Ley de la Industria Eléctric*) in March 2021. In summary, this Reform to the Electric Industry Law was to favour the state owned Comisión Federal de Electricidad (CFE)/Federal Electricity Commission, over the more competitive prices the private sector can generate electricity at. AMLO has long been accusing the private sector for taking advantage and excessive profiteering, and has spent much of his term trying to overhaul the energy sector in favour of the CFE and state oil and gas company Petroleos Mexicanos (Pemex).

The Reform currently provides new rules for generators to access the grid, prioritizing the energy produced by the CFE power plants, regardless of the generation costs, in the following order:

1. "Energy Produced by Hydroelectric facilities"
2. "Energy Generated by other (sic) CFE generation facilities […] such as nuclear, geothermal, combined-cycle and thermoelectric"
3. "privately-owned wind and solar energy" and
4. "privately-owned Combined-Cycles […] and the rest of the other energy generation technologies."

We are of the view that AMLO's push for electricity reforms would continue to be one of the main challenges Mexico would face going into 2022.

<u>A New Constitutional Reform</u>

More recently in October 2021, AMLO pitched to Congress a constitutional reform to continue to boost state control of the electricity market, giving the CFE ~56% of the power market and putting it in charge of setting terms for private generators. This bill would also reserve future lithium extraction for the state and do away with energy regulators, grouping their functions under the Energy Ministry and the CFE. Although Mexico has yet to produce lithium, AMLO said 8 existing concessions for extracting lithium would remain in the control of the private sector should the industry develop in the coming years.

Overall, the continued push for squeezing out private electricity companies would lead to higher electricity prices (not helping that inflation is already at multi-year highs), a greater reliance on fossil fuels by stifling the clean and efficient plants of the private sector, and affect the competitiveness of the country. But more importantly, the Reform violates the United States-Mexico-Canada Agreement (USMCA) that Mexico is a part of (the reform contravenes Mexico's commitments to non-discriminatory treatment and investment), exposing Mexico to litigation. Not only would the Reform itself be cause for investments to fall greatly, but also the fear of Mexico falling out of the international agreement which has helped its trade so much. The impact of this reform, if approved at its current form, might be on par or even larger than the cancellation of the Mexico City airport in 2018. This Reform continues to be one of the main drivers to our bearish view on the Mexican economy.

Trade Idea: Long USDMXN

<u>Narrative</u>

As suggested by the fundamentals, we are bearish on the peso going into 2022. Mexico's ability to recover from the pandemic and tackle emerging variants are doubtful. Combined with an increasingly hawkish U.S. Fed, we view this as an opportunity to long USDMXN. Reasons for the trade include: (1) commodity currencies such as the Australian, New Zealand dollar and Peso are the most vulnerable to a covid-19 resurgence. Although the Omicron variant is not as severe as the Delta variant, it is more contagious and has a higher risk of transmission. This would require some measures which will slowdown global growth and demand, causing money to flow out of risky assets into safe haven assets like the USD (2) Fed Chairman Jerome Powell dropping the word 'transitory' from their vocabulary, signalling a more hawkish Fed - in line with the long-term bullish trend for the USD as indicated by the DXY (3) President AMLO's new pick to lead Banxico is believed to be loyal towards AMLO and likely to usher in an era of low rates

<u>Catalysts</u>

The omicron variant is still in its early stages but has already spread to 63 countries, surpassing the speed of infection of the Delta variant according to the World Health Organisation (WHO). The WHO also commented that they were unsure as to why the Omicron variant was spreading so fast. Heading into the holiday season, few countries have implemented additional pandemic related restrictions, further suggesting that the spread of the Omicron could accelerate. This would increase the risk-off sentiment and come as a headwind for EMFX like the Peso.

Additionally, the Feds are likely to speed up the end of their bond buying program. Their increasingly hawkish stance suggests that rate hikes could come sooner than expected which will help strengthen the USD.

<u>Technicals</u>

USDMXN broke above the 20.9 resistance in late November for the first time since March to hit a yearly all-time high of 22.1 and is likely to retest the previous 20.9 resistance as support before continuing the uptrend. We view this support as a good entry point with a stop loss of 20.45 which is the next support level (S1) . From the chart, USDMXN has been rising since September, forming a rising wedge pattern. Furthermore, RSI has been making higher highs and lower lows, indicating there is still much room for USDMXN to run.

Trade

Entry: 20.95
Take Profit: 22.1
Stop Loss: 20.45
Risk Reward Ratio: 2

NUS INVESTMENT SOCIETY

Global Macro Department –Brazil (UNDERWEIGHT) Date: 15th December 2021

Analysts

Chan Tze Hoe
Global Macro Analyst
e0774959@u.nus.edu

Basic Information

Real GDP(US$)	$1.620 trillion
M2(US$)	4142 billion
CPI	6018
PPI	155.82
Con. Confidence	44
Stock Index	IBOVESPA
Currency	BRL

Chart info

Overview of Brazil's Economy

- Brazil occupies about half of Latin America's land mass and is the 13th largest economy in the world by nominal GDP and 8th largest by purchasing power parity (PPP).
- GDP per sector: 5.91% Agriculture, 17.65% Industry, 62.92% Services. Main contributors in the service sectors are hospitality, Information Technology (IT) and retail sales.
- International trade constitutes 28.46% of Brazil's GDP, with total exports of goods and services accounting for 14.11% and total imports accounting for the remaining 14.35%.
- Brazil's top exports consists of soybeans, crude petroleum, iron ores, maize, and wood pulps. Its top imports are refined petroleum, crude petroleum and vehicle parts.
- Main trading partners: China (28.11% exports, 19.89% imports), the United States of America (USA) (13.25% exports, 17.15% imports) and Argentina (4.3% exports, 5.95% imports).

Summary of events in the past 6 months

Brazil's Disappointing Post-Pandemic Economic Performance

- Economic recovery for Brazil is lagging despite efforts by the government in reopening the economy and a relatively high population vaccination rate standing at 74.8%. Brazil's economy is currently in a recession with contractions occurring in both the 2nd and 3rd quarter of 2021.

Brazil's Rising Inflation

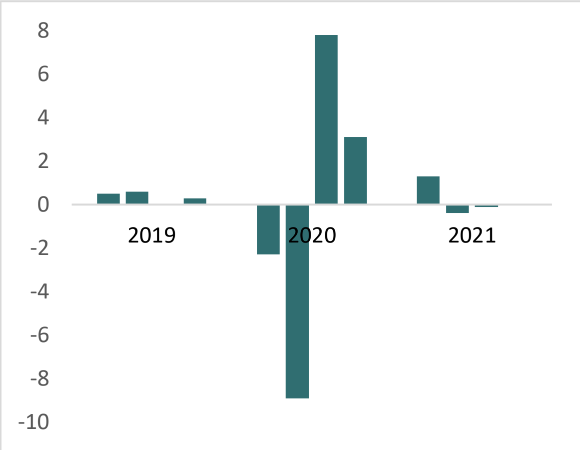
- Inflationary pressure is a major concern for Brazil's economy, with annual inflation rate increasing to 10.67% by October, which is more than double the inflation rate back in January at 4.56%.
- Persistent inflation is caused by a combination of both external and internal factors. External factors include rising energy and commodity prices whereas internal factors range from extreme drought and the weakening Brazilian Real.
- The Banco Central do Brazil (Brazilian Central Bank) has taken on a hawkish stance towards rising inflation. It has increased the country's interest rate (Selic rate) for the 6th consecutive time in October

Brazil's Political Woes

- To boost his popularity in the upcoming election, President Jair Bolsonaro is eyeing an increase in social payments for the nation's fiscal policy. His proposal requires the government to overrule the constitutional cap for public spending, which severely undermined investors' confidence.

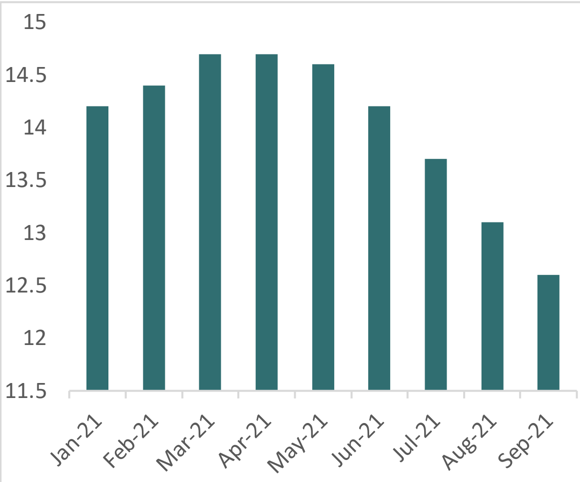
- The divergence between fiscal and monetary policies are straining Brazil’s economy, which stem from a conflict of interest between the government and the central bank.

Figure 1: Brazil's GDP Growth



Source: Trading Economics

Figure 2: Brazil's Unemployment Rate



Source: Trading Economics

Figure 3: Breakdown of Inflation Forecast

Region/Country	2021	2022
Latin America	11.9%	10.4%
Africa	10.6%	9.5%
EMEA	7.8%	6.7%
Asia Pacific	1.2%	2.3%
Eurozone	2.4%	2.2%
U.K.	2.4%	3.5%
U.S.	4.5%	3.7%
World	3.7%	3.5%

Source: Bloomberg

Brazil Struggles With Economic Recession

While most countries are enjoying strong growth in the aftermath of the COVID-19 pandemic, Brazil is losing its momentum and has failed to capitalise on the reopening of the global economy. Economic indicators are far from desirable, and expectations for the Brazilian economy are relatively pessimistic, with weak investors' outlook and poor consumers' confidence across the board.

Negative GDP Growth (Performance Worse Than Forecasted)

Recent data has shown that Brazil has entered an economic recession, with 2 consecutive quarters of negative GDP growth. Based on Fig. 1, it shows that although the economy had experienced a 1.3% GDP growth in the 1st quarter of the year, this is immediately followed by a 0.4% contraction in Q2 (against a forecast of 0.2% growth), and another 0.1% contraction in Q3 (against an estimate of no growth).

The economic recession is attributed to a multitude of factors. Key factors include the soaring commodity and energy prices driving inflation upwards, high interest rate introduced by the central bank, extreme weather conditions affecting agriculture produce and lastly, an ever-weakening Brazilian Real.

Falling Unemployment Rate

On the bright side, Brazil's unemployment rate has been decreasing. This can be observed in Fig.2 where unemployment rate in September has fallen to 12.6% following an all-year high of 14.7% in March and April. The recovery in the labour market is, however, expected as pandemic restrictions are increasingly loosened domestically. Furthermore, the recovery in the labour market may increase inflation rate, which offset the potential economic gains from lower unemployment.

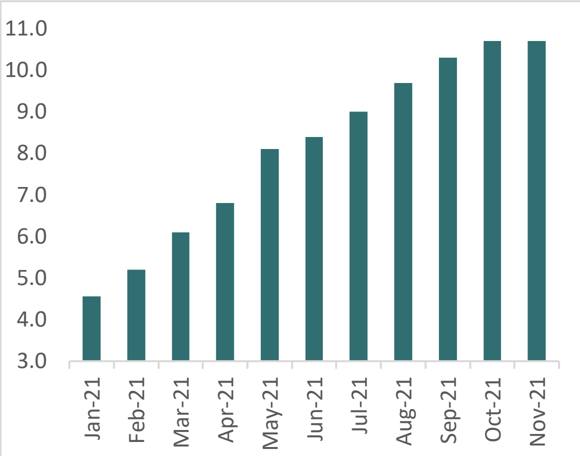
Are Interest Rate Hikes The Answer To Rising Inflation?

Like many other countries globally, the post-pandemic recovery of Brazil is haunted by persistent inflation. In fact, the Latin America region that Brazil is in is suffering the most from inflation shocks. This is observed in Fig. 3 shows how the inflation forecast for 2021 and 2022 is heavily skewed against the Latin America region.

For Brazil, the annual inflation rate as of October 2021 is at 10.67%, which is a staggering increase when compared to the 4.56% at the start of the year (as observed in Fig. 4). In response to this, the Central Bank of Brazil has consistently been increasing the Selic rate to mitigate rising inflation and maintain price stability, Fig. shows how the central bank has consistently introduced rate hikes for the 6th consecutive time in 2021, with the Selic rate settling at 7.75% for October, which is a stark increase from the 2.0% rate at the start of the year. Nonetheless, based on the data provided, it seems that interest rate hikes are relatively ineffective in quelling Brazil's inflation woes. We believe the reasons for this lie within the factors contributing to Brazil's inflation and how well monetary policy can tackle them.

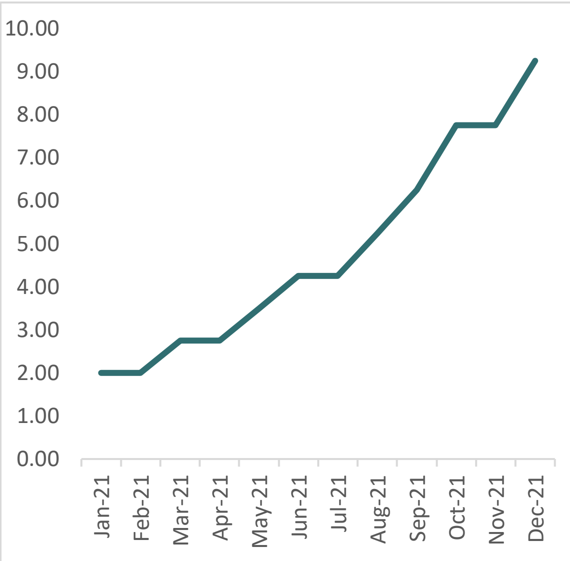
Global Supply Chain Disruption

Figure 4: Brazil's Inflation Rate



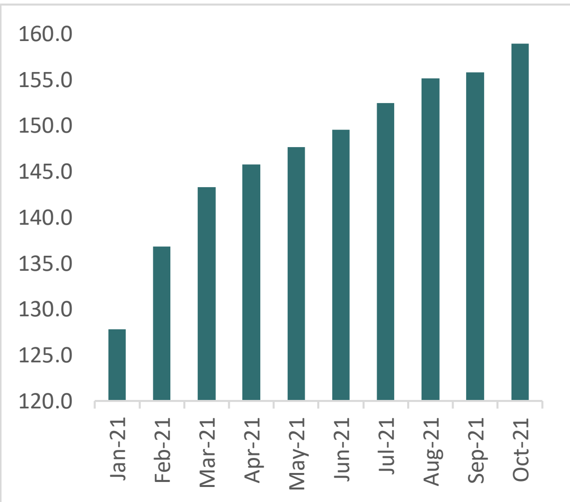
Source: Trading Economic

Figure 5: Brazil's Interest Rate



Source: Bloomberg

Figure 6: Brazil's Producer Price Index (PPI)



Source: TheGlobalEconomy

Externally, a key reason for Brazil's soaring inflation is the rising commodity and energy prices globally due to post-pandemic supply shocks that cannot keep up with the increasing demand of the recovering global economy. To illustrate this, Brazil's Producer Price Index (PPI) has been rising substantially in this year alone as seen in Fig. 6, from 120.80 points in January to an all-time, historic high of 158.95 points in October.

In this case, monetary policies such as increasing interest rate (aggressively) is simply not optimal in tackling inflation caused by supply-side factors. They are more effective in managing excessive demand in an economy instead.

<u>Extreme Weather Conditions</u>

Internally, extreme weather conditions have also caused supply shortages domestically. Unusually dry weather causing droughts has led to surging electricity costs due to dwindling reserves at hydropower dams, of which hydroelectricity accounts for a staggering 65% Brazil's electricity source. In fact, Brazil's hydroelectric reservoirs in the southeast and central west, which represent almost three-fourths of the country's installed capacity, have fallen to 17% amid the worst drought in 91 years. This led to a significant increase in reliance for energy imports (specifically natural gas) from the U.S. and Argentina to curb the power crunch, in which the price of natural gas has also been rising significantly. Brazilian national oil company Petróleo Brasileiro (Petrobras) reported a 43.5% year/year increase in the demand for domestic natural gas during the third quarter. The agricultural sector was also affected as the dry spell hurt key Brazilian crops such as corn, which drove food prices up.

Again, we believe that interest rate hikes are rather blunt when tackling internal supply-side constraints, and the less-than-optimal infrastructure in Brazil.

<u>Weakening Brazilian Real</u>

Another pivotal contributor to soaring inflation is Brazil's weakening currency, which make imports pricier due to worsening terms of trade. While the consecutive increase in Selic rate by the central bank should supposedly increase the demand for Brazilian Real, this did not occur. A key reason for this is the dwindling confidence of investors in the Real, which is largely driven by concerns over President Bolsonaro's controversial fiscal policy (refer to the next section on Fiscal Dilemma). In fact, the value of Brazilian Real is currently at record lows as seen in Fig. 6. which shows a bearish trend for BRL/USD.

As hiking interest rates no longer follows the convention of subsequently increasing currency strength, it is not optimal in tackling the weakening currency that is driving inflation upwards.

With the factors mentioned above, we believe rising inflation is here to stay for Brazil in the near future. With global sentiments shifting increasingly in favour of treating post-pandemic inflation as persistent rather than transitory (with prominent central banks such as the U.S. Feds signalling earlier rate hikes), it is very likely rising inflation due to global supply chain disruption will be here to stay. Coupled with a domestic energy framework that lacks diversification and relies too heavily on hydroelectricity, Brazil's increase dependency on energy imports such as natural gas will only worsen the situation.

Figure 6: Bearish BRL/USD

Source: Bloomberg

Furthermore, given its central bank's hawkish tendency, we believe that interest rate hike as a response to inflation will still be employed moving forward, even though its effectiveness is widely debatable.

A Government At Odds With Its Central Bank: Brazil's Fiscal Dilemma

With the 2022 elections on the horizon and waning support across the population, President Jair Bolsonaro is desperate to regain the majority's approval. One way of doing so is by introducing a large fiscal package, known as *Auxilio Brasil*. *Auxilio Brasil* is an upgrade to the nation's long-standing income-distribution program, with Bolsonaro promising higher government payments then before for needy households struggling from the aftereffects of the pandemic. However, the planned increase in government spending for this package would mean that the government would have to spend beyond its constitutional cap for public spending.

Bolsonaro's attempt to bypass the nation's public spending cap has led to a drastic decrease in confidence in Brazil's fiscal discipline. For a country with debt amounting up to 81.3% of its GDP, the new fiscal package would only worsen Brazil's debt load and exacerbate concerns surrounding Brazil's poor fiscal rectitude.

What's more worrying is the apparent divergence between monetary policy introduced by the central bank and the fiscal policy pursued by the current government. On one hand, the central bank is trying to keep inflation at bay by raising interest rate which would, under normal circumstances, promote capital inflow and strengthen the Real, which subsequently reduces imported inflation. Yet, on the other hand, the government's perceived lack of fiscal discipline is driving confidence in the Real to an all-time low, which only serve to aggravate soaring inflation as the currency's value plunges to record lows as observed in Fig. 6.

Additionally, with the Real's decline aggravated by concerns over fiscal discipline , a more hawkish stance is required from the central bank to put a brake on the decline. Yet, further increases in interest rate may not be favourable for the economy due to the nation already being in a recession. Furthermore, the most recent Selic hike of 1.5% was shrugged off by traders despite being the largest rate hike in nearly two decades (and yet the Real still fell). This likely means that unless an even more substantial rate hike is introduced, the Real will not be stabilising anytime soon, especially amidst persistent doubts around the government's fiscal solvency and increased geopolitical uncertainties as the presidential election draws closer.

Global Macro Department – Canada (OVERWEIGHT) Date: 15th December 2021

Analysts

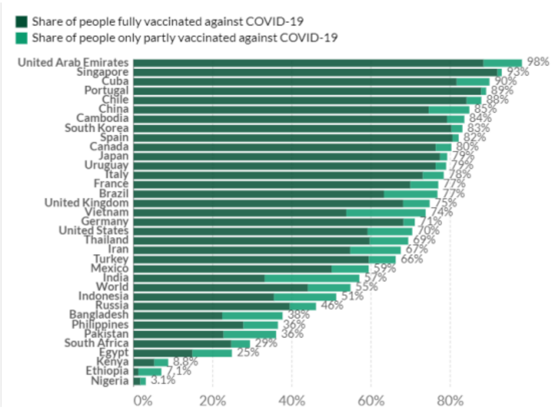
Chan Tze Hoe
Global Macro Analyst
e0774959@u.nus.edu

Basic Information

Real GDP(US$)	$1.644 trillion
M2(US$)	$2286b
CPI	143.90
PPI	117.70
Con. Confidence	54.09
Stock Index	TSX Composite
Currency	CAD

Chart info

Figure 1: COVID-19 Vaccination Rates



Source: Our World in Data

Overview of Canada's Economy

- Canada is the second largest country in the world by land area and is globally ranked 9th based on nominal GDP and 15th in term Purchasing Power Parity (PPP).
- GDP per sector: 1.6% Agriculture, 28.2% Industry, 70.2% services. Real estate, oil and gas extraction, healthcare, and finance are key industries which contribute to Canada's GDP.
- International trade constitutes 65.4% of its GDP, with total exports accounting for 31.9% whereas imports constitute the remaining 33.5%.
- Top 5 crude oil exporter globally, with crude oil export constituting 14% of its GDP. The Loonie (Canadian dollars) is widely regarded as a commodity-driven currency, with crude oil market performance being the largest single contributor to FOREX.
- The United States of America (USA) is Canada's largest trade partner. Around 74% of its total exports and 51% of its total imports are to and from the USA respectively. Following that is China constituting 4.8% of Canadian exports and 12.47% of its imports.
- Trade agreements such as NAFTA and USMCA have facilitated easy trade of goods and services between Canada and its key trading partners, which enable it to leverage on its trade dependent economy

Summary of events in the past 6 months

Post-Pandemic Recovery

- Post COVID pandemic recovery for the Canadian economy is relatively favourable, with significant GDP growth as the economy reopens and a low unemployment level that rivals the pre-pandemic performance.

High Vaccination Rate

- As of December 2021, Canada has a vaccination rate of 80.27%, which place it among the top 10 countries globally for the percentage of population that is vaccinated against COVID-19.

Rising Inflation

- Inflationary pressure remains a major concern for the Canadian economy. Inflation rate has consistently exceeded 3%, the upper band of the Bank of Canada's control range since April 2021 at 3,4%, and subsequently reaching an all-time high of 4.7% in October.

Bank of Canada's Monetary Policy

- Despite persistent inflation, the central bank initially insisted on maintaining overnight rate at 0.25% at least till 2022 Q3 (dovish). It believed that supply shocks contributing towards inflation are transitory and the absorbance of economic slacks should be prioritised via low interest rates.
- Near the end of October, the feds adopted a more hawkish stance by halting its QE programme and signalling a potential earlier rates hike around April 2022 due to increased concern over persistent supply constraints driving prices up.

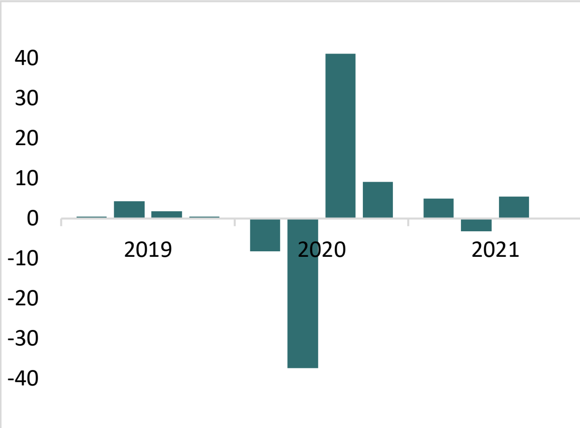
Crude Oil Price Development

- OPEC+'s refusal to increase oil production amidst soaring energy costs and increasing global demand has significantly push crude oil prices to record highs. This benefited and strengthened the Loonie as a commodity currency. However, the discovery of the Omicron variant has led to increased uncertainties and a significant fall in crude oil prices (around 20% decrease). Whether this is an overreaction by the market remain to be seen.

Concerns and Uncertainties over Omicron Variant

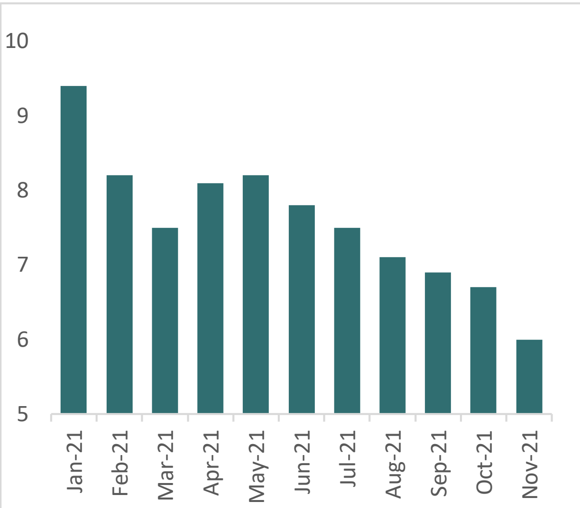
- Potential impacts of the Omicron variant on Canada's growth trajectory are relatively obscure at the moment. This is due to the lack of information regarding the variant, which is causing a delay in market reaction due to uncertainties.

Figure 2: Canada's GDP Growth



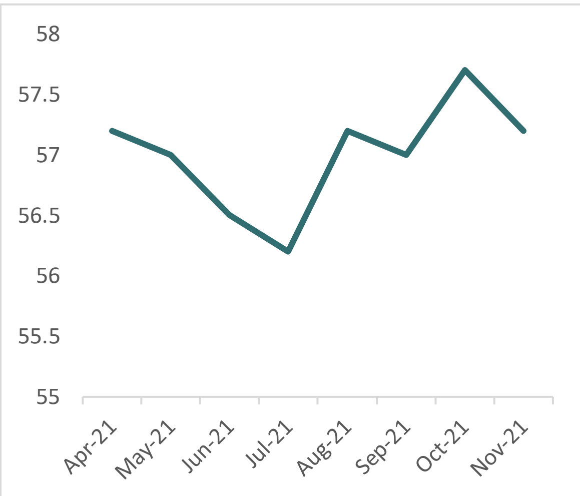
Source: Bloomberg

Figure 3: Canada's Unemployment Level



Source: Bloomberg

Figure 4: Canada's Manufacturing Purchasing Manager Index (PMI)



Source: Trading Economics

Economic Indicators Are Favourable, But Will They Last?

Canada's post pandemic recovery is relatively well off when compared to other economies globally. Economic indicators such as GDP, PMI and unemployment rate all point towards a steady rate of recovery for the Canadian economy. Nonetheless, some concerns remain. Although overall economic recovery seems optimistic, certain sectors of the economy are still struggling from the effects of the pandemic.

<u>GDP Growth Rate (Growth Exceeded Forecasted Level)</u>

As seen from Fig, 2, Canada's GDP experienced an annualised growth rate of 5.4% in Q3 of 2021, which exceeded economist estimates (at 3.3%). This is good news following the economy's disappointing performance in the 2nd quarter of the year, in which the economy's output contracted by 1.1% following a new wave of COVID-19 cases. Much of the expansion in Q3 is attributed to a drastic increase in household spending by 18% within the 3-month period, reaching USD 938 billion. This is the second highest increase since the early 1960s. We believe this is an indication of increasing domestic confidence and a more positive economic outlook for the near future.

The increase in household spending has also allowed Canada to offset weaknesses in other critical sectors of the economy. For example, in the automobile sector which constitute 11.9% of Canadian exports, global lockdowns, surging energy prices and semi-conductor chip shortages have affected its recovery. Output level for automobiles in Q3 remain 1.4% lower than Q4 of 2019 (pre-pandemic level). This hampered Canada's export performance which is currently experiencing a contraction (although losses were partially offset by the rise in crude oil prices).

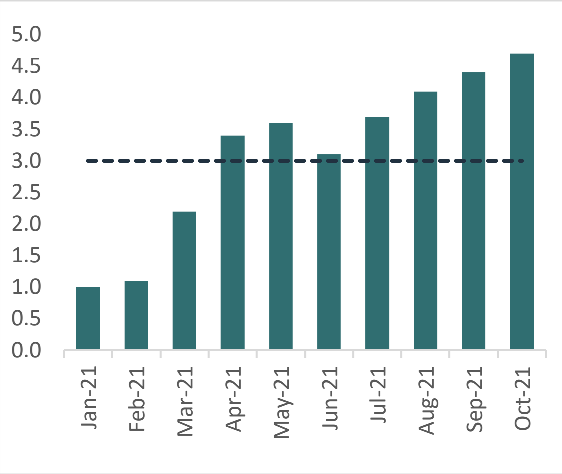
<u>Employment Level Post Pandemic (Exceeded Pre-Pandemic Level)</u>

Canada unemployment rate fell significantly in 2021 following the reopening of its economy. In October 2021, the unemployment rate fell from 6.9% to 6.7%, which further fell to 6.0% in November. In fact, employment level in Q3 of 2021 is approximately 30,000 higher than it was in February 2020, in which the nation experienced a loss of 3 million jobs at the initial stage of the pandemic. We believe this is a good indication for Canada's continued recovery. From this, we observe that Canada's labour market rebound is so strong that its employment level has surpassed pre-pandemic lows, a respectable performance. On the contrary, other countries are only reaching pre-pandemic employment level, except for Australia which saw its employment level also surpassing pre-pandemic level in July 2021.

<u>Manufacturing Purchasing Managers' Index (PMI)</u>

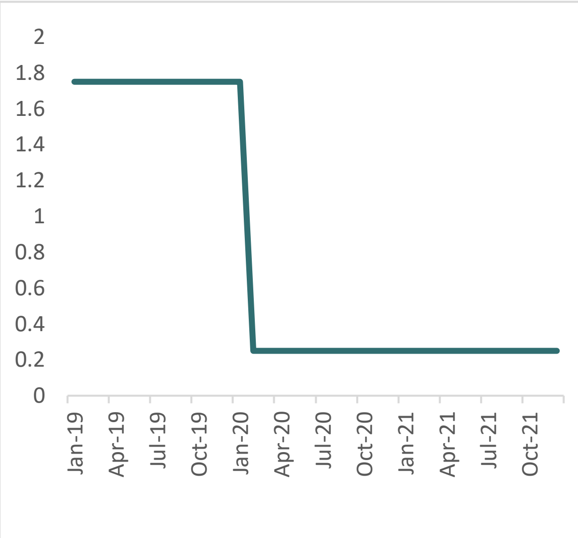
Rising optimism surrounding Canada's economic recovery is also indicated by increasing manufacturing PMI as observed in Fig. 4. The chart indicates that PMI has been steadily increasing since the economic contraction in Q2. While PMI in November 2021 came in at 57.2, a slight decrease from a 7-month high of 57.7 in October 2021, we believe that the overall increasing trend signify a positive outlook for the economy. Moreover, given the significance of Canada's

Figure 5: Canada's Inflation Rate



Source: Trading Economics

Figure 6: Canada's Interest Rate



Source: Trading Economics

Figure 7: Correlation Between CAD and Crude Oil Prices

Source: TradingView

manufacturing sector (about 10% GDP), we believe this optimism translates to expectations of continued economic growth.

Economic Progress Or Price Stability: The Canadian Interest Rate Dilemma

Since the start of the 2nd quarter of 2021, Canada has been facing persistent inflationary pressures. As seen in Fig. 5, inflation reached a record 4.7% in October 2021, its highest level since 2003 and way above the central bank's target range of 1-3%. A similar phenomenon is occurring across the globe, where economies are experiencing persistent price hikes due to global supply shortages brought about by supply chain disruptions. Coupled with increasing demand for goods and services as the global economy reopens amidst higher vaccination rate and the push towards an endemic approach to tackle COVID-19, it has led to increased prices.

For Canada, the strongest price pressure can be traced towards transportation, which experienced a 10.1% increase in price as of October. This is largely due to surging energy costs globally. Other areas such as prices of shelter and food has also increased by about 5% and 4% respectively.

<u>Initial Dovish Response By The Bank of Canada (BoC)</u>

Initially, the BoC adopted a rather dovish stance towards rising inflation. In fact, Canada's overnight interest rate has been deliberately kept at 0.25% since the start of the pandemic in 2020 (and expected to remain as such till the 2nd half of 2022) as seen in Fig. 6. This is despite rising expectations of a rate hike to alleviate rising prices which are reaching unprecedented levels. The bank listed 2 key factors for its decision:

1. Supply bottlenecks contributing towards inflationary pressures are transitory, and price volatility is only in the short-term.
2. Economic slacks remain and there are still room for recovery and progress.

Essentially, the BoC prioritised economic progress over price stability, hence its reluctance to raise rates.

<u>Potential Shift Towards Hawkish Stance During The BoC's October 2021 Meeting</u>

During its October 2021 monetary policy meeting, the BoC decided to end its quantitative easing programme and signalled an acceleration for the potential timing of future interest rate hike (from 2nd half 2022 to as early as April 2022). This was a quite a hawkish surprise as the BoC initially indicated that it would only half its weekly bond-buying from CAD 2 billion to CAD 1 billion as part of its October monetary policy decision instead of ending it completely. The acceleration in rate hike was also a drastic shift from its dovish approach just weeks ago. This is in lieu of concerns over supply disruptions being more persistent than expected in driving up prices Furthermore, Canada's Q3 performance has shown that economic recovery is favourable, which allows the bank to push forward interest rate hike without significantly compromising economic growth.

Interestingly, the interest rate hike signal did not significantly affect the CAD's strength in the FX market. Admittedly, some traders have been betting against the initial dovish stance of the BoC, it should nonetheless have been a relatively hawkish surprise. Although the CAD did strengthen based on hourly performance, there was no significant changes in its daily performance. We believe that this is possibly a result of other market movements and market expectations taking place which has dampened the bullish impact the rate hike should have on the CAD. An example is the expectation of a fall in crude oil prices due to the recent correction in oil prices after a yearly high of more than USD 85 per barrel in late October.

Regardless, we can only assume which among the two factors (rising inflation and positive economic recovery) is more influential in dictating the BoC's hawkish stance, which we believe is crucial in predicting any further changes in the BoC's stance. Nonetheless, given the strong economic recovery by Canada in Q3, we believe that inflation will have a greater weightage in influencing rate changes moving forward.

Has Crude Oil Price Reached Its Limits?

Crude oil prices had been rapidly increasing near the end of the 3rd quarter and the early weeks of the 4th quarter. This is due to supply shortages amidst a rise in global demand for energy. With key entities such as OPEC+ remaining adamant on maintaining a restrictive output policy, it is only natural for crude oil prices to soar, with prices exceeding USD 80 per barrel at its peak. As a commodity-driven currency, the Loonie benefited from this phenomenon, with the currency's value rising in tandem with crude oil prices. As observed in Fig. 6, CAD/SGD was bullish as crude oil prices (Brent) soared.

Unfortunately, crude oil prices started declining around mid-November. This is due to multiple factors, including the surge in Europe's COVID cases which led to expectations of economic slowdown. Additionally, increasing concerns over the Omicron variant amidst the pandemic is also pivotal in the recent drastic fall in crude oil prices near the end of November. While the World Health Organisation has indeed labelled Omicron as a 'variant of concern', the dominant notion as of now is that the drastic fall in crude oil price due to Omicron is irrationally excessive and prices should revert to the price range of USD 70-80/barrel. Nonetheless, we believe it is unlikely that oil prices will once again exceed the $80 mark anytime soon, as supply shortages is expected to be alleviated in the near future.

Falling crude oil prices is indeed a valid concern for Canada. A depreciating currency may exacerbate rising inflation due to higher import prices. Moreover, Canada export performance might also worsen as rising crude oil prices had been pivotal in offsetting losses in the nation's export. Nonetheless, we do not expect oil prices to decrease significantly to an extent of hurting Canada's export, as the drastic price fall near the end of November is very probably an overreaction. This is supported by evidence of oil prices recovering moving into the month of December. Based on the Brent benchmark, after a steep drop in oil prices to USD 69 per barrel on 1 Dec, the price per barrel now fluctuates between USD 73-76 in the month of December.

Figure 8: CAD/BRL Daily Chart

Source: Trading View

Trade Idea: Long CADBRL

<u>Narrative</u>

As previously highlighted under our fundamental analysis, the Canadian economy seems to align with a positive economic outlook in the near future. This is complemented by a record level of employment level within the Canadian population in Q3 (which surpassed pre-pandemic employment level) as well as a higher than forecasted Q3 GDP growth. Stable economic recovery has also allowed the BoC to switch in favour of a more hawkish stance moving forward, signalling potential earlier rate hikes as early as April 2022 rather than the 2nd half of 2022 as initially planned to tackle inflation. With increased confidence in Canada's economic growth as well as potential rate hike coming earlier, we believe that the CAD will appreciate relative to the BRL due to increased capital inflow.

On the other hand, Brazil's economic outlook is much less favourable. With negative GDP growth in both Q2 and Q3 of 2021, the economy is in a recession. Additionally, despite the central bank's aggressive rate hike to tackle inflation, it had no effect on the weakening BRL due to a lack of confidence among investors. Bolsonaro's attempt to spend beyond the constitutional cap only further exacerbated this in the wake of fiscal uncertainties. With a bleak outlook for both the Brazilian economic recovery and the value of BRL, we believe the BRL will depreciate against the CAD.

<u>Catalysts</u>

As uncertainties revolving around Omicron continues to subside, we believe that crude oil prices will rally given the drastic fall in crude oil prices stemming from the fear of this new variant. As a commodity-driven currency, we expect the Loonie to strengthen in tandem with the expected recovery in crude oil price. Additionally, while we expect the Brazilian central bank to always be ahead of its Canadian counterpart for rate hikes, we believe that widespread uncertainties and doubts over Brazil's fiscal rectitude and geopolitics uncertainties will continue to weaken the Real.

Technical Analysis

Based on the daily chart in Fig. 8, we observe that the CAD/BRL has been bullish near the start of October. The 20EMA crossed above the 50 EMA and the 100 EMA on 24 Sep and 27 Sep respectively, which provides confirmation of the bullish trend. A bearish trend is also observed between 1 Nov and 11 Nov (20EMA still remain above 50EMA, 100EMA). We attributed this to the fall in crude oil prices (during that period) due to the general expectations of a correction in crude oil prices in that period. A bullish pennant can be seen forming as the CAD once against rally against the BRL (after the bearish period), signalling a potential bullish breakout that we intend to capitalise on.

Our stop loss, take profit, and entry points are based on previous key levels on the daily chart. Our take profit point at 4.60 and stop loss point at 4.38 are key level of resistance/support that have been tested multiple times throughout the year. Our entry point at 4.45 has also been tested several times, but more importantly, it allows us to ascertain that a bullish breakout is indeed happening before entering the trade. Our risk reward ratio for this trade idea is 2.25.

Entry: 4.45
Take Profit: 4.60
Stop Loss: 4.38
Risk Reward Ratio: 2.25

Disclaimer