Global Macro Department – European Union (SLIGHTLY OVERWEIGHT) Date: 15th December 2021

Analysts

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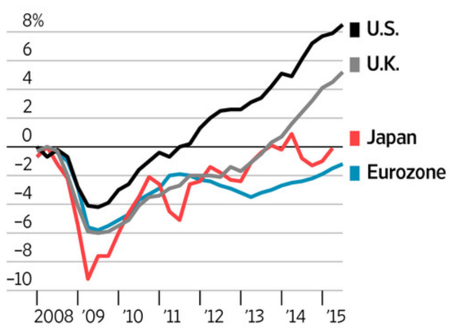
Basic Information

Real GDP (USD Trillion)	15.28 (2020)
M2 (€ Trillion)	14.54 (Oct-21)
CPI	111 (Oct-21)
PPI	119 (Sep-21)
Con. Confidence	-8.2 (Nov-21)
Currency	Euro (EUR)

Source: Trading Economics

Chart info

Figure 1: Sluggish growth in Eurozone relative to that of its peers in the U.S.

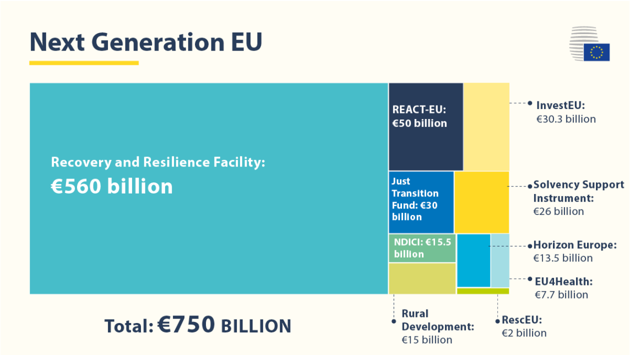


Source: Wall Street Journal

Overview of the European Union

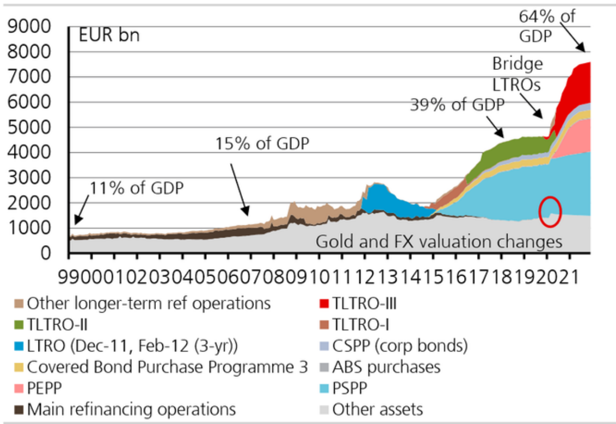
- The European Union (EU) is an economic and monetary integration of 27 member countries as of today, after the protracted exit of the U.K. from the trading bloc. Of these 27 members, 19 adopt the Euro (€) as their official currency. These 19 countries make up a subset of the EU, which is known as the Eurozone or Euro area (its official name). The Euro is the world's second reserve currency.
- The Central Bank of the EU is the European Central Bank (ECB), which has been chaired by Christine Lagarde since 2019. The ECB, as part of the bigger Eurosystem, is tasked with ensuring price stability by managing and implementing a single monetary policy across the Eurozone, as well as by managing foreign reserves.
- The European Commission is a legislative body that develops policies, laws, and funding programmes for all 27 members of the EU, and Ursula von der Leyen has held the presidency of the Commission since 2019. Notably, the Commission organized a video conference of world leaders in May 2020 to raise funds for Covid-19 vaccine development.
- Among the developed economies, the Euro area has been entrenched in a decade of sluggish growth and low inflation (Fig. 1). This was due to a combination of weak productivity growth and demographic factors, and led to underperformance in its benchmark equity market index (Euro Stoxx 50) relative to that of the U.S. (S&P 500).
- The Services sector is the growth engine of the EU, making up 70% of GDP, composing the likes of industries like R&D, business professional & technical services, transport, travel and ICT. Manufacturing is the secondary driver of growth in the European economy, making up 25% of GDP with its main export products being machinery & equipment, pharmaceutical products, and motor vehicles.
- There are 4 main economies within the EU – Germany, France, Italy and Spain, which each contribute 25%, 17%, 13% and 9% to EU GDP respectively. This focus of this report will therefore be on these 4 countries.
- The main trading partners of the EU are primarily the U.S., the UK and China. The U.S. takes the pole position as the EU's biggest export partner, followed by the UK and China. In terms of imports, China is the EU's largest partner, followed by the U.S. and the UK.

Figure 2: Next Generation EU plan



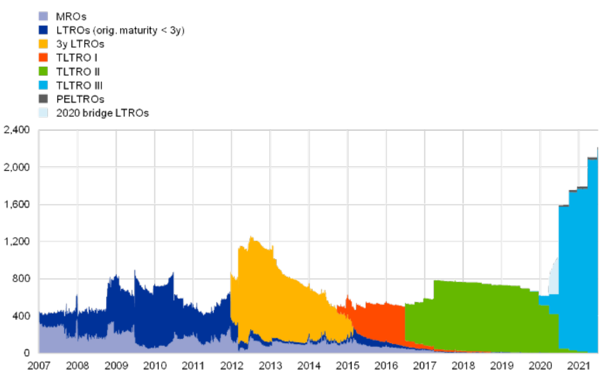
Source: EU Council

Figure 3: ECB Balance Sheet expansion (1999-2021)



Source: Haver Analytics, UBS estimates

Figure 4: Targeted Longer-Term Refinancing Operations (TLTROs)



Source: ECB

Summary of Events in the Past 6 Months

Fiscal Policy

- Talk of a fiscal union within the Eurozone to complement the Economic and Monetary Union (EMU) were revitalised along with the rollout of the Next Generation EU (NGEU) plan, which will disburse €750 billion over 6 years – the largest stimulus package ever (Fig. 2), and amounting to around 5.5% of total Eurozone GDP.
- On the country level, Germany and France announced recovery plans worth a considerable €130b and €100b respectively, which run to the end of 2021 and 2022. Meanwhile, Italy and Spain drew up larger plans amounting to €224b and €140b respectively, but which also cover a longer period – to 2027 and 2026 respectively.

Monetary Policy

- The Pandemic Emergency Purchase Programme (PEPP) was launched in March 2020 (Fig. 3), entailing purchases of private and public sector securities that are currently worth a total of approximately €1.52 trillion as of 26 November 2021.
- The favourable borrowing conditions under the Targeted Longer-Term Refinancing Operations (TLTRO), which "provide financing to credit institutions" (*Source: ECB*), will also be under scrutiny at the December meeting – where a decision will be made to extend it or continue in a similar form. Three series of TLTROs (Fig. 4) have been launched to date in 2014, 2016, and 2019, with the latest programme (TRTRO III) running till June 2022.
- The ECB also launched a Strategy Review in early 2020, of which the outcome directly led to an upward revision of its inflation target to 2% over the medium term, with overshoots of the target allowed.

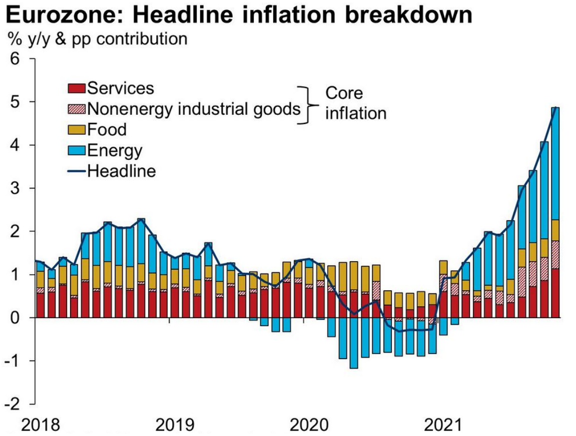
Geopolitical Events

- In tune with the energy price crisis, Russia is using the approval of the Nord Stream 2 pipeline as leverage to limit the flow of Russian energy supplies to Europe. Renewed pressure and opposition from numerous fronts have successfully delayed the opening of the pipeline.
- Russia has been building up a significant military presence on the Ukrainian border, fuelling fears that it may soon launch an invasion of Ukraine. Given the importance of Ukrainian agriculture on global food supply, a broad-based conflict in Ukraine could lead to destabilisation of global food supply and cause a spike in prices. An invasion of Ukraine could also spark off a refugee crisis as Ukrainian civilians seek to flee the frontline. The EU response will also be closely watched, as a weak and incoherent response could indicate that the EU is not prepared to stand its ground on geopolitical issues and therefore invite further pressure from adversaries.

European Union

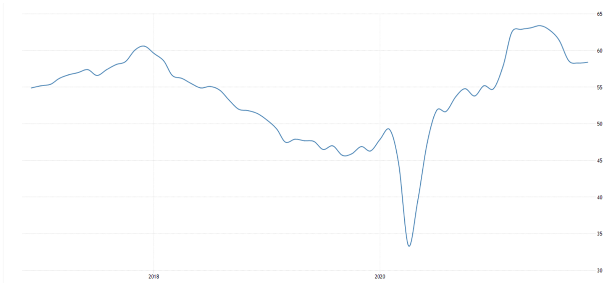
Inflation: Here to stay? Not really sure how to feel about it, something in the way you move…

Figure 5: EU Headline Inflation (HICP) Breakdown



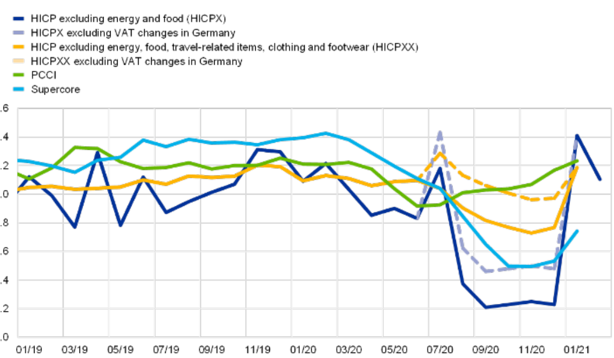
Source: Oxford Economics, Haver Analytics

Figure 6: Euro area Manufacturing PMI



Source: Trading Economics

Figure 7: EU HICPX (HICP excluding volatile components: Energy and Food)



Source: ECB

The debate over prices in Europe, in the words of Rihanna, goes "round and around and around…". On first glance, prices across the European Union look more fiery now than ever, with headline inflation hitting the highest level in over 13 years (4.1% in Oct'21, see Fig. 5), led by soaring energy prices, recovery of pent-up demand after lockdowns, and global shortages of certain raw materials and products.

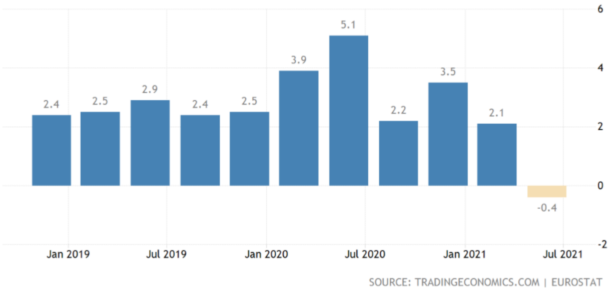
The energy crunch gave the global economy a rude awakening to the effects of years of underinvestment in traditional energy sources, as well as the unrealistic pace of transition towards green energy. This was exacerbated by President Vladimir Putin using approval of the Nord Stream 2 pipeline as leverage against the Germans, a play on the release of more Russian energy supplies beyond their contractual obligations to help ease the energy crisis in Europe. The pipeline was a project meant to double the capacity of the existing undersea route from Russian gas fields to Europe, and was completed in early September 2021. Thus far, the project's approval has met with bureaucratic hurdles and renewed pressure and opposition (in the form of sanctions) from stakeholders like the U.S., Ukraine, Poland and Slovakia, which have collectively brought about delays to the completion of the project, leading to limited gas flows arriving from Russia in response. This is a developing geopolitical situation that has repercussions on price pressures and stability in the region. It could either set the stage for heightened cooperation between Europe – led by Berlin – and Russia, or on the other end of the spectrum, Germany caving in to political pressure from Washington to further distance themselves away from Moscow.

This acceleration in prices is in no little part thanks to the supply chain bottlenecks that have left businesses and consumers vulnerable and exposed, against a backdrop of the impending (potentially harsh) winter and slowing momentum in economic growth. Euro area composite PMI has trended downwards since Jul'21, falling to a six-month low of 54.2 in Oct'21 although a reading above 50 still indicates expansion in business activity. This was predominantly driven by services sector activity picking up, with manufacturing growth remaining lacklustre due to the persistence of supply chain constraints (manufacturing PMI came in little changed in October at 58.3, see Fig. 6).

Price effects were particularly pronounced in Germany, although it is expected to fade as inflationary distortions — like the VAT hike, Harmonised Index of Consumer Prices (HICP) weight changes in Jul'21, and energy base effects related to higher fuel prices in Jan'21 – drop out of year-on-year inflation figures. Moreover, after stripping out volatile components in the inflation basket such as energy and food, the resulting Harmonised Index of Consumer Prices excluding energy and food (HICPX, see Fig. 7) has remained right around pre-pandemic levels (Feb'20), casting doubt on the inflation narrative that has been making its rounds on global headlines.

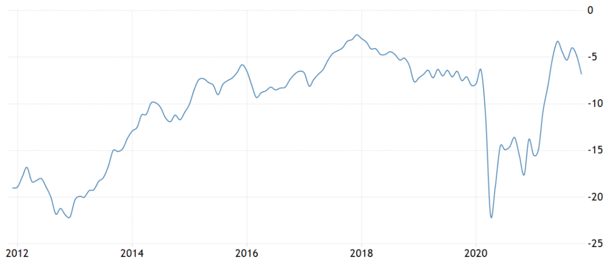
With excess slack in the Euro area, the underlying factors that have led to record-high prices in the U.S. so far appear to be idiosyncratic and relatively unique to the Americans. These include: i) stronger demand for used cars, following the U.S.'s

Figure 8: Labour market cost inflation (measured by Euro area wage growth)



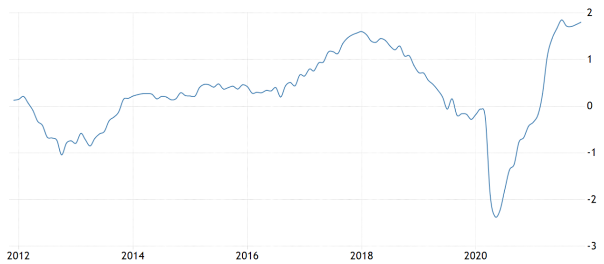
Source: Trading Economics, Eurostat

Figure 9: Euro area Consumer Confidence



Source: Trading Economics, European Commission

Figure 10: Euro area Business Confidence



Source: Trading Economics, European Commission

easing of containment measures ahead of the Euro area, ii) preferences for private over public transport, and iii) a larger weight of used cars in headline CPI (U.S.) relative to headline HICP (euro area). Therefore, inflationary pressures have thus far been relatively more muted compared to that in the States.

For inflation to align with the here-to-stay narrative, we would need to observe increasingly broad-based price pressures alongside rising labour cost pressures, as these have been relatively more muted than elsewhere (read: the U.S.) with Euro area wage growth coming in at -0.4% YoY in 3Q'21 (Fig. 8). Given the abundance of short-term work and furlough schemes geared towards supporting a return to the workforce, and by extension towards improving labour supply, these initiatives would need to prove ineffective over a longer time horizon to provide a realistic basis for worries over wage-push inflation. This could either be due to i) a sheer lack of talent, or ii) a fundamental shift in labour force demographics that result in persistent skill mismatches. We believe that if such a scenario plays out, the demand-supply labour market mismatch may rear its ugly face in the form of rising wages to combat rising prices, as worker unions are in a stronger bargaining position. Undesirable second-round effects could also present themselves, which would then make a case for sustained inflation that exceeds the ECB's target.

Taken together, we are inclined to posit that Euro area inflation should be reaching – or has reached – its peak, and is likely to fall in the coming year before increasing gradually to a higher average terminal value than pre-pandemic levels. This is mostly in line with the ECB's strategic overhaul (*see below: Monetary Policy at the Effective Lower Bound*) to raise their inflation target to 2% – with room to overshoot it when needed – as part of their post-pandemic recovery roadmap. ECB President Christine Lagarde's repeated pushbacks against rate hike bets lend further credibility to this expressed goal, in spite of a nuanced change in the ECB's October meeting minutes to account for the possibility of higher medium-term inflation – the emphasis remains on these price pressures dissipating sooner rather than later. Accordingly, economic sentiment of both consumers (Fig. 9) and producers (Fig. 10) should bottom soon (if they haven't already) and start rising again.

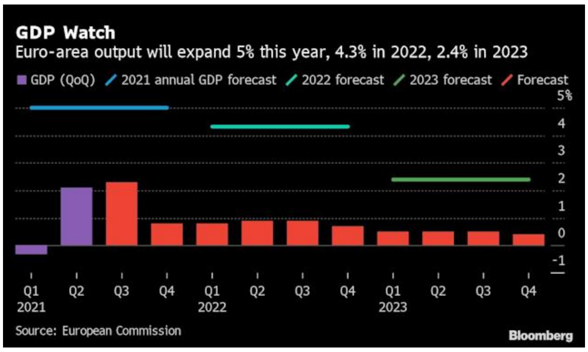
Next Generation European Union

Fiscal EUnion? We think not…

The landmark NGEU fiscal plan had raised hopes amongst Europhiles that the EU may finally be moving towards at least a quasi-fiscal union. Indeed, the NGEU plan has improved the growth outlook for the EU. The European Commission has already begun disbursing NGEU funds, which will be spread over 6 years from 2021 - 2026. At €750 billion, the size of the NGEU is roughly 5.5% of the total Eurozone GDP, the largest stimulus package ever (Fig. 2) and the hallmark of the EU's efforts to help member state economies emerge from the pandemic. The NGEU includes seven instruments, of which the largest being the Recovery and Resilience Facility (RRF) that is composed of grants worth a total of €312.5b and loans worth €360b.

Economic modelling by researchers at the ECB estimate that the NGEU could increase real output in the Eurozone by 1.5% in the medium term. However, we think that the NGEU is strictly a one-

Figure 11: ECB GDP Growth Projections



Source: Bloomberg, European Commission

Figure 12: ECB Euro area HICP Projections

Source: European Commission

Figure 13: EUR/USD Cross-Currency Basis

Source: Bloomberg

Figure 14: EUR/USD FX Rate

Source: TradingView

time off plan that was only possible because of the exceptional circumstances and severity of the impact of the pandemic on global and Eurozone economic growth. Even then, there were significant difficulties encountered in persuading the Frugal Four of Austria, Denmark, the Netherlands to agree to the NGEU.

On the country level, among Europe's Big Four, Germany and France announced recovery plans worth a considerable €130b and €100b respectively, which run to the end of 2021 and 2022. Meanwhile, the southern Europeans, Italy and Spain, drew up larger plans amounting to €224b and €140b respectively, but which also cover a longer period – to 2027 and 2026 respectively. The budget for these plans entailed direct support to businesses (France's Solidarity Fund), to households (Germany's €300 child premium), and targeted support for local government.

European Central Bank

The Lady isn't Tapering

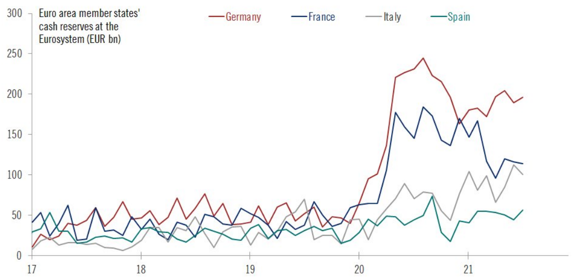
During the September 2021 meeting, the ECB decided to announce a "moderately lower pace of net asset purchases under the PEPP" as compared to in Q2 and Q3. This is in line with the ECB's intention of ending PEPP in March 2022, which should be confirmed at its December meeting. However, Lagarde was quick to push back on market talk of a tapering of PEPP, and insisted that the reduction in net asset purchases under PEPP was just a recalibration. This decision is in the backdrop of upward revisions to the ECB's projections, as expected GDP growth was revised upwards from 4.6% during the June meeting to 5.0% (Fig. 11). Headline inflation was also revised upwards to 2.2% in 2021, 1.7% in 2022 and 1.5% in 2023, from 1.9%, 1.5% and 1.4%, respectively (Fig 12).

Too much medicine?

The Pandemic Emergency Purchase Programme (PEPP) was launched in March 2020 in response to market liquidity stresses caused by the Covid-19 pandemic-induced recession. Under PEPP, a total of €1.85 trillion of private and public sector securities can be purchased. As of 26 November 2021 , the total purchases made under PEPP stands at approximately €1.52 trillion - this means that roughly €330 billion more of assets may be purchased under this program. The PEPP program will be ended when the Governing Council of the ECB determines that the financial stress from Covid-19 is over, but they have indicated that the earliest possible timeframe for doing so is in March 2022. Maturing principals from securities purchased under PEPP will be rolled over until at least the end of 2023, and the future roll-off will be managed to be consistent with the monetary stance of the ECB.

This has led to the ECB purchasing around 95% of the total EGB issuance (estimations by ING) in the Eurozone economies between February 2020 and July 2021, with the result that there is significant collateral shortage of Euro-denominated securities, as visible through the decrease in the EUR/USD cross-currency basis. Cross-currency (xCcy) basis is the excess premium or discount factored into the quoted price of a FX xCcy basis swap or FX forward. In a standard EUR/USD basis swap, the notional amounts at the spot FX rate are exchanged, along with periodic interest payments where 3M Libor and 3M Euribor plus a spread is exchanged. This spread represents the premium or discount for swapping Euros for Dollars. The increasingly negative EUR/USD

Figure 15: Cash reserves of Eurozone member states at the Eurosystem



Source: ECB, Pictet Wealth Management

Figure 16: EUR 5y5y Inflation Swap

Source: Bloomberg

basis, at -30.6 bps (Fig. 13), indicates there is a surge in dollar demand relative to euros – euro deposit holders are willing to pay a 30.6 bps premium to swap Euros for Dollars. We think that the collateral shortage in Europe has placed significant downward pressure on EGB yields, forcing institutions to swap euros for dollars and purchase US bills instead. The rapid rise in USD demand relative to EUR explains the recent fall in the EUR/USD FX rate (Fig 14).

Path to "Normality"

Even as the ECB reduces its asset purchases, the impact on EGB yields should be low-to-moderate. Firstly, fiscal spending will be lower than before as large deficits in 2020 were a result of lockdowns, which are unlikely going forward. Secondly, the NGEU funds are starting to be disbursed to governments to fund spending, reducing their need to rely on issuances for funding. Thirdly, Eurozone governments have significant cash balances at the Eurosystem, which they can draw down upon to fund spending (Fig. 15). These cash balances are similar to the Treasury General Account (TGA) which the United States Treasury maintains at the Federal Reserve. As such, the rise in net supply of EGBs going forward may be more muted, which will help to keep Eurozone yields low. Lagarde has also indicated in the October Monetary Policy Statement press conference that the market pricing for ECB interest rate lift-off is too early, and the ECB does not expect the conditions for lift-off to be met anytime soon. The December meeting will be crucial as the ECB will determine whether TLTRO will be extended or continued in a similar form, and whether APP purchases will be stepped up (from its current pace of €20 billion/month). Crucially, this may mean that peripheral spreads will be placed under greater stress, as APP purchases of public sector securities are guided by the ECB capital key (determined by the size of constituent economies) rather than by need. Economists expect the ECB to announce a bridging asset purchase programme that would ensure a smooth transition from the end of PEPP (should PEPP be ended) – a way of cushioning any 'cliff edge' effect that arises.

Monetary Policy at the Effective Lower Bound

Since 2003, the year of the ECB's last Strategic Review, there have been significant changes to the economic structure of the Eurozone. Therefore, on 23 January 2020, the ECB launched a Strategy Review to ensure that they can continue to deliver on their mandate of price stability. The outcome of the Review was presented on 8 July 2021. As a direct result of the Review, a few key changes to ECB strategy occurred. Prior to the Strategy Review, the ECB's policy was to achieve an inflation rate "below, but close to, 2%". The ECB revised the inflation target to a symmetric 2% over the medium term, with overshoots of the target allowed. It noted that the interest rate in the Eurozone economy was close to the effective lower bound and thus "requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched". Under this framework, the ECB will allow for inflation to run moderately above target for transitory periods. In line with this new framework, the ECB has also revised its forward guidance. Under this forward guidance, 3 conditions have to be met before the ECB will start raising interest rates. Firstly, the Governing Council must see "inflation reaching two per cent well ahead of the end of its projection horizon". To clarify, the ECB's projected horizon extends from 2021 - 2024 by the December

2021 meeting. Secondly, the 2% inflation target must be achieved "durably for the rest of the projection horizon". Thirdly, the Governing Council must judge that "realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term." Inflation shocks that are expected to fade away before the end of the ECB projection horizon will hence not be sufficient to trigger rate hikes by the ECB. As part of the policy review, the ECB will incorporate owner-occupied housing costs in the Harmonised Index of Consumer Prices (HICP). The HICP is the ECB's measure of the Eurozone inflation rate and is used by the ECB to gauge progress towards its price stability objective.

Going Forward

Given Eurozone economic data and the ECB Strategy Review, and the strong and consistent stance from Lagarde, we do not expect a rate hike any time before 2024. Lagarde has been very clear through her public communications that she sees inflation as transitory. Furthermore, market indicators of the medium-term inflation outlook are stable and below the ECB's target of 2.0% - the EUR 5y5y inflation swap (Fig. 16), which measures average expected inflation over the five-year period that begins in five years' time, is currently at 1.8569%, below the ECB's symmetrical 2.0% target. Unless this level rises over above 2.0% persistently for a few months, it is unlikely than the ECB would perceive medium-term inflation expectations to be unanchored from the symmetrical 2.0% objective. As such, any significant dip in EURIBOR STIR futures for time periods before 2024 should be bought, conditional on no changes in the ECB's views on the medium-term inflation outlook.

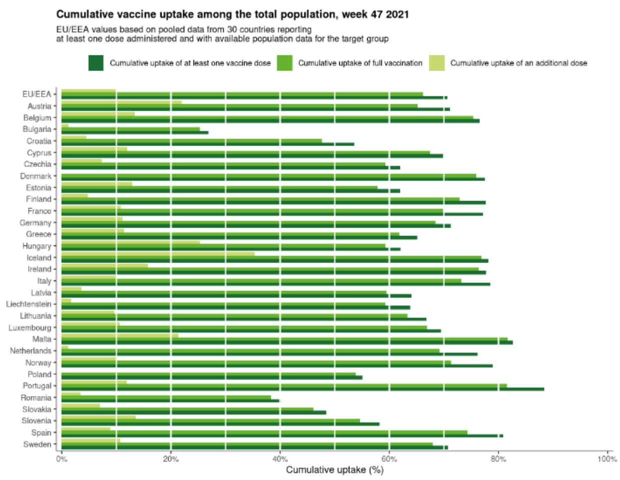
Don't look now, but they just keep coming…

The Fifteenth Letter in the Alphabet: Greek's 'Little O'

Omicron: a sequel to the thorn in the flesh of the global economy after Delta – the first Variant of Concern (VoC) as classified according to the SIG Variant classification scheme.

All along since we began to understand the scale of the healthcare crisis on our hands, we knew that there would be emerging variants that would derail the trajectory of the world's economic recovery. Nonetheless, when the news of Omicron first broke, markets still panicked – arguably to a disproportionate extent, given that much was still unclear about the new variant. Travel was halted on all travel into the EU from Southern Africa in late Nov'21, despite the critical level of 70% of the EU adult population being fully vaccinated by Aug'21 (Fig. 17).

Figure 17: Vaccination figures in Europe

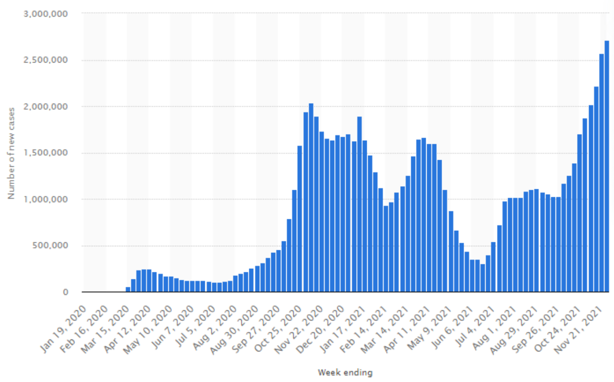


Source: ECDC, EU

Figure 18: Number of Covid-19 cases in Europe

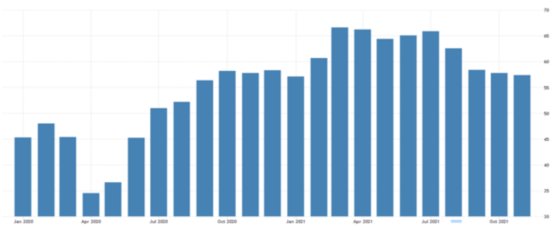
Since August, Europe has seen record numbers of new Covid-19 cases (Fig. 18) primarily of the Delta strain, although the similarly record high number of deaths was limited to countries with low vaccination rates. Once-unthinkable vaccine mandates have come into play in Austria, been supported by incoming German chancellor Olaf Scholz, and was also raised by EU Commission Chief Von Der Leyen.

Aside from hindering a full reopening across the Euro area, which would have been a much-needed boon for the services sector that contributes greatly (70%) to the region's growth, the seemingly endless developments to the pandemic – particularly the aforementioned surge in Covid-19 cases as we enter the cold



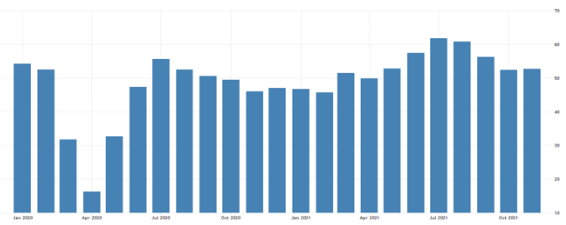
Source: Statista

Figure 19: German Manufacturing PMI



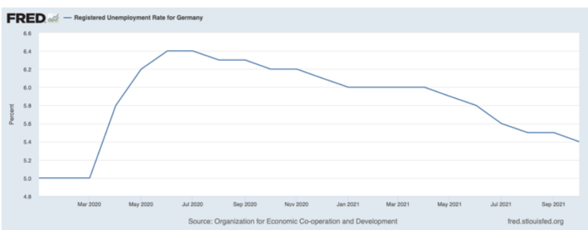
Source: Trading Economics

Figure 20: German Services PMI



Source: Trading Economics

Figure 21: Unemployment rate in Germany



Source: Board of Governors of the Federal Reserve System

season – have also hurt Europe from an international trade flow cum knock-on effects perspective. Lockdowns in countries that are key manufacturing nodes, including the likes of emerging Asian countries like Malaysia and Vietnam, would further add to the production (and labour force) constraints that were already putting unwanted upward pressure on prices.

Perhaps more worryingly, the Euro area's third largest trading partner, China, adopted a rather contrarian zero-Covid ambition, with the attendant rolling draconian local lockdowns that continue to cause severe disruptions in the global supply chain. For example, China's ports serve as a key trade hub by being the world's third-busiest container port, which exacerbates supply shortages when they impose port quarantines to keep the virus completely out of China.

Germany

Continuing the Recovery

The German economy is driven primarily by services, which account for 68.6% of GDP, and secondarily by manufacturing, which accounts for 30.7% of GDP. Broadly speaking, both manufacturing and services have experienced a robust recovery and are on track to return to pre-pandemic levels. German manufacturing PMI (Fig. 19) indicated that the manufacturing sector (which in fact started way before the pandemic, in January 2019) has been expanding since bottoming in July 2020, while German services PMI (Fig. 20) show that been growing since August 2020. Accordingly, consensus estimates of German GDP growth for 2021 are at 2.8%, and GDP is expected to reach the pre-pandemic level in Q1 2022. On the labour front, after peaking at 6.4% in June and July 2020, the unemployment rate in Germany has fallen to 5.4% in October 2021 (Fig. 21), just 0.4% off from the pre-pandemic level. However, this rapid recovery, together with supply-chain issues, have caused inflation to surge, with German CPI climbing to 5.2% in November. This will certainly raise eyebrows at the ECB, as public pressure to address rising inflation mounts.

Goodbye Merkel, Hello Olaf!

Angela Merkel has served as Chancellor of Germany since 2005, and announced her intentions to step down from the role in October 2018. As such, she did not lead her Christian Democratic Union (CSU)/Christian Democratic Union (CDU) centre-right alliance in the 2021 German federal elections. Without her presence, the CSU/CDU under new leader Armin Laschet performed poorly, obtaining just 24.1% of the vote, compared to the center-left Social Democratic Party (SDP), which won 25.7%. The Greens (14.8%), Free Democratic Party (FDP) (11.5%), Alternative for Germany (AfD) (10.3%) and The Left (4.9%) won the bulk of the remaining vote share. As none of the parties had a majority, a coalition government had to be formed. On 23 November 2021, the SDP, Greens and FDP finalised a tripartite coalition agreement, with Olaf Scholz of the SDP set to be Chancellor.

What colour is the German Condor?

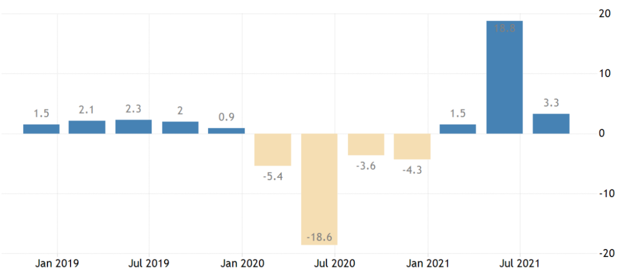
With a change in the German coalition composition (aptly nicknamed the traffic light coalition based on the colours of the three parties), there is heightened uncertainty over the new direction of policy. On fiscal policy, the new coalition has agreed that the debt brake, which is a constitutional rule which limits borrowing by the federal government to just 0.35% of GDP per year, will be reinstated in 2023. This debt brake was suspended for the years 2021 - 2022 due to the necessity for fiscal expansion to cushion the economic slowdown caused by the pandemic. With the finance ministry handed over to the FDP as part of the coalition's division of ministries, we expect German fiscal policy to remain conservative. This puts a dent in hopes in pro-European centrists' dreams of a more consolidated pan-Europe fiscal policy. However, with the coalition being new, and involving 3 parties with differing political platforms, we see increased risk of indecision in German policy. The ability of the coalition to sustain consensus across policy issues will need to be monitored carefully to gauge downside risks that the coalition may falter.

France

A Note of Optimism

Relative to Germany (manufacturing 28% of GDP), the services-dominated French economy (manufacturing 16% of GDP) took much smaller of a hit from logistical bottlenecks. Economic growth surpassed expectations, with YoY GDP growth clocking in at 3.3% (Fig. 22), on the back of a swift rebound in consumption. Labour numbers remained relatively solid in spite of the labour shortage issues that are featuring prominently across many developed nations in recent times. Despite unemployment creeping up to 8.1% in 3Q'21, above market expectations of 7.8%, employment rate (as measured according to ILO's definition) and activity rate climbed 0.5% and 0.6% respectively to reach their highest levels ever. Moreover, high vaccination rates in France (Fig. 23) allowed her to weather the economic turbulence brought about by the Delta variant in the early second half of 2021.

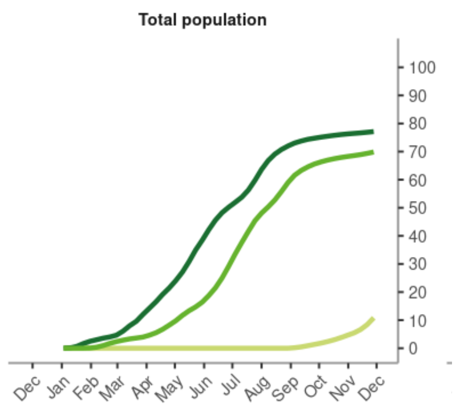
Figure 22: France Year on Year GDP growth



Source: Trading Economics, INSEE, France

France has not been passive on the fiscal front either, with its Sep'20 two-year "plan de relance" (fiscal recovery plan) and more recent fiscal support initiatives – including a gas price freeze – expected to kill two birds with one stone: support rebounding growth, while easing the burden of high energy prices on consumers.

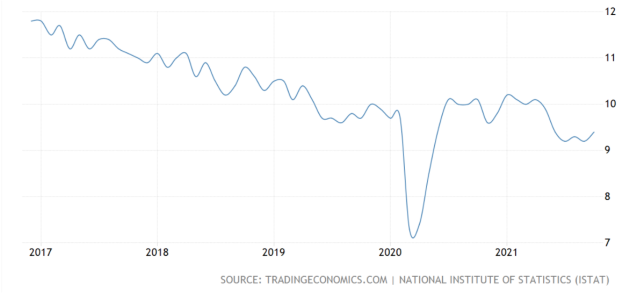
Figure 23: Vaccination rate in France (Total Population)



Source: ECDC, EU

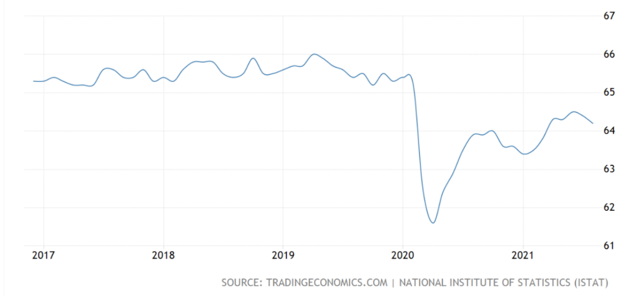
We will be keeping a close eye on developments regarding the Presidential and parliamentary elections in Apr'22 and Jun'22 respectively, for signals on the progress of/ inhibitions to the implementation of incumbent President Macron's policy reforms. It is likely that Macron will be re-elected into office, although his opponent in the second round is yet to be decided. However, any attempt at major reform will be met with vehement opposition in the hyper-polarised political climate, giving him much tighter policy room to manoeuvre around. With France taking up EU presidency in 2022, these elections also have wider implications on efforts to integrate the Euro area with the attendant reform of the fiscal (union) framework.

Figure 24: Italy Unemployment Rate



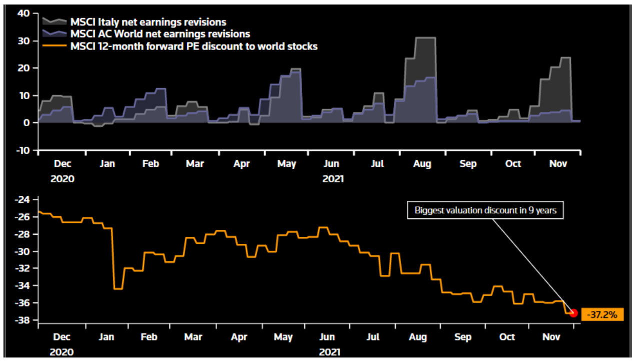
Source: Trading Economics

Figure 25: Italy Labour Force Participation Rate



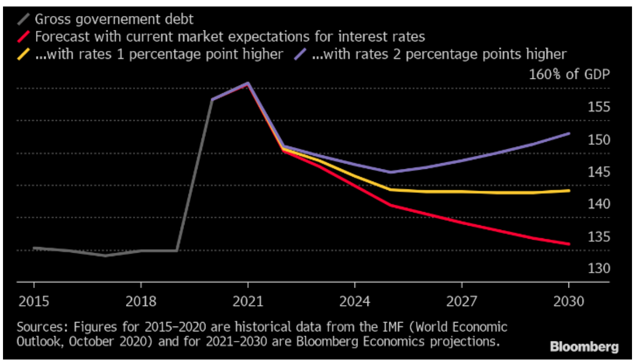
Source: Trading Economics

Figure 26: Earnings Revisions in Italy



Source: Refinitiv Datastream, Reuters

Figure 27: Italian Government Debt projection as a % of GDP



Source: Bloomberg

Italy

There Is (Usually) Always A Rainbow After The Rain Falls

Much like Germany, supply disruptions continue to be the kryptonite to sustained and resilient growth in the Italian economy. The emergence of the Omicron variant has also aroused concerns in the tourist-dependent country, which has already underperformed in 2020 during the first wave of infections.

Nonetheless, economic performance is expected to climb above its historical average growth rate under the leadership of former ECB chief Mario Draghi. This performance is notably bolstered by the investment opportunities provided by the NGEU recovery fund's rollout (its largest instrument being the Recovery and Resilience Facility), as well as the multi-faceted support measures entailed within Italy's National Recovery and Resilience Plan – where it has invested national resources in addition to ReactEU, a component of NGEU, to the tune of over €170b worth of stimulus in total since the start of the pandemic. Accordingly, analysts note that one of the most consistent positive earnings revisions are currently happening in Milan (Fig. 26).

On the labour front, unemployment rates (Fig. 24) rose in 2020 but have since fallen below pre-Covid levels (coming in at 9.4% for Oct'21 vs 9.7% in Feb'20), although the same cannot be said for its labour force participation rate (64.2% in Aug'21 vs 65.2% in Feb'20, see Fig. 25). As more people resume their search for jobs, participation should correct to a level around its historical average, which was gradually increasing since its 2010 lows. The downside risk to this projection may emerge given that some people may have left the work force for good, since the onset of the pandemic and the resulting economic downturn.

Italy's high public debt level (unstable fiscal position) also proves worrisome should the ECB accelerate the policy tightening cycle in 2022, as materially higher bond yields would curtail Italy's realisation of its post-pandemic growth potential – not least due to higher debt financing costs (Fig. 27). Nonetheless, Prime Minister Draghi is betting on higher growth, a supportive low rates environment, and the credibility of fiscal policies to justify his administration's new public-finance plan, which although widens Italy's debt-to-GDP ratio in the short term (projected at 153.5% this year), will bring it down gradually over the decade (145% in 2024).

Uncertainty at the Palace

With incumbent President Mattarella not seeking a second term, the Quirinal Palace (seat of the Italian Head of State) will also see a new tenant in Feb'22. Whether it will be the current Prime Minister Draghi (the widely-hailed frontrunner for the presidency) or another prestigious figure (who has yet to stand out in the presidential race) that takes over the reins, it is almost certain that such uncertainty does not sit well with markets, as it has wide-ranging implications on Italy's structural reforms and fiscal roadmap – a similar theme shared with France.

Spain

Still taking a siesta... for now

Out of the 4 largest economies in the Eurozone, the Spanish economy has experienced the weakest recovery, with a Q3 2021 GDP that is still more than 6% lower than Q4 2019, prior to the pandemic. Unemployment remains high at 14.7%, compared to 13.7% in February 2020 (Fig. 28). To compound this weak recovery, annual inflation has been moderately high and stood at 5.4% in October 2021. The lethargic recovery of the Spanish economy may be attributed to its structural weaknesses - there are high rates of youth unemployment (30%) and long-term unemployment (32%), both of which may lead to a lower-skilled workforce and unemployment hysteresis. However, there are hopes that the government's recovery plan, bolstered by NGEU funds, will help to rejuvenate the Spanish economy. Indeed, despite the recovery on a GDP basis being weaker, services (Fig. 29) and manufacturing PMI (Fig. 30) data appear to be rather optimistic, rebounding together with its Eurozone peers.

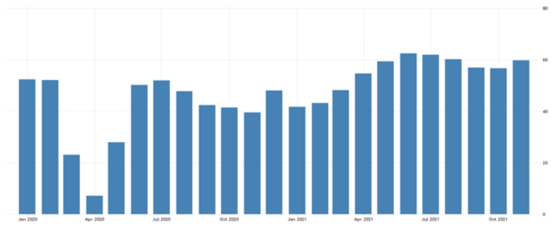
Resuscitating the Spanish Bull

Spain will receive up to €140 billion of funds over a period of 6 years under the NGEU. Half of the funds will be from grants while the other half will be as loans. The Spanish government has outlined its plan (lasting from 2021 to 2026) to spend these funds, aiming to create 802,000 jobs through investments and structural reforms in areas such as labour regulation, taxation and pensions. The main areas of spending are as follows: 40% on energy transition and green projects, 28% on digitalisation initiatives, 10% on education and training and 7% on research and development. The European Commission has approved the plan and will disburse the funds on the condition that the structural reforms are carried out as in the plan. The first Spanish budget involving the use of these EU funds was passed on 2nd December 2021 by the Spanish parliament.

Figure 28: Unemployment Rate in Spain

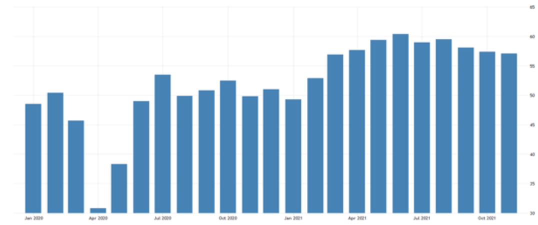
Source: Board of Governors of the Federal Reserve System

Figure 29: Spanish Services PMI



Source: Trading Economics

Figure 30: Spanish Manufacturing PMI



Source: Trading Economics

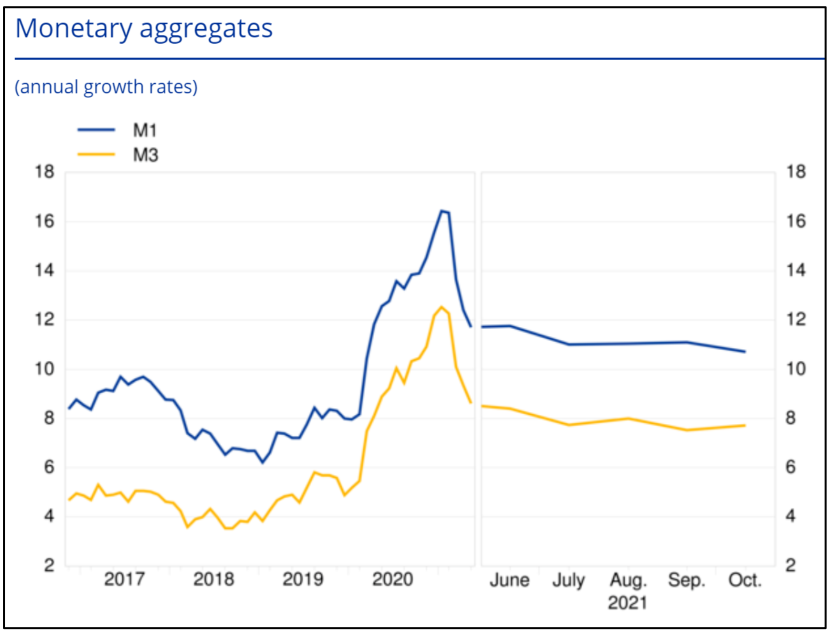
Figure 31: Euro Stoxx 50 Index Weekly Chart

Source: Trading View

Figure 32: Euro Stoxx 50 Index Daily Chart

Source: Trading View

Figure 33: Euro area broad money supply (M1/M3) annual growth rate



Source: ECB

Trade Idea: Long Euro Stoxx 50 Index

We believe that Europe's benchmark index's recent risk-off move (with the VIX volatility index spiking 54% on Black Friday), in reaction to the uncertainty brought about by the Omicron variant, is likely unwarranted, particularly against the backdrop of a positive earnings season in 3Q'21 that indicated resilience in the face of supply chain concerns and rising energy prices. This healthy correction provides us with a good opportunity to enter a long position, taking advantage of a secular long-term upward move in the next 3-6 months.

The multiple waves of Covid-19, what with the Delta and (more recent) Omicron variants' emergence, have laid out a bumpy road to the powerful "restart" that we were promised after vaccines became available. In particular, the services-dominated European economy does not take well to prolonged movement restrictions and several other containment measures, resulting in the recent drawdown of approximately 6%.

Nonetheless, based on encouraging forward earnings estimates for 2022, we see potential for the blue-chip heavy Euro Stoxx 50 Index to rally to its highest levels since 2008, on the back of secular growth trends and catch-up growth opportunities within European equities.

In addition, the ECB's ultra-loose monetary policy stance with rates being kept at the effective lower bound (at least for 2022) as aforementioned in our monetary policy outlook, coupled with ample liquidity in the market from years of quantitative easing and broad money supply growth in the Euro area (Fig. 33), have led to investors accepting higher valuations on a historical basis in their hunt for higher yield. Having returned next to zilch for investors over the past decade, European equities have never been as cheaply valued relative to their U.S. counterparts as today (Fig. 34), making for higher relative upside and attractiveness to investors.

The downside to the trade would materialise if medical health experts arrive at a conclusion that the currently available vaccines are ineffective at countering the transmissibility and severity of the new variant. This would put a bullet in all hopes of a full economic reopening within the Euro area, let alone international border reopenings. In turn, this would weigh on

Figure 34: MSCI Europe Index P/E valuation relative to MSCI USA Index

Source: Bloomberg, MSCI

companies' sales and bottom line through higher operating costs (wages, cost of inventory) and loss of revenue, particularly those in the services sector, which will lead to a move against our position.

Technical Analysis

The Euro Stoxx 50 Index has established higher highs and higher lows (on the weekly charts) since Nov'20, establishing a bullish trend. Further to add, a golden cross pattern was observed in early Sep'20, with the 50-day Moving Average crossing above the 200-day Moving Average.

We set our entry price at the lower of the Bollinger bands, with a stop loss of approximately 2.51% below the entry price. There is a strong support level around 3,890 that has been retested three times without breaking, demonstrating strong buying pressure at this price. We will take a profit of about 10.5% at the higher of the Bollinger bands, around the 4,410 level.

Trade

Long Euro Stoxx 50 Index (.STOXX50E)

Entry: 3,990.00
Take Profit: 4,410.00
Stop Loss: 3,890.00
Risk Reward Ratio: 4.20

NUS INVESTMENT SOCIETY

Global Macro Department – Switzerland (NEUTRAL)

Date: 15th December 2021

Analysts

Lin Bak Hin
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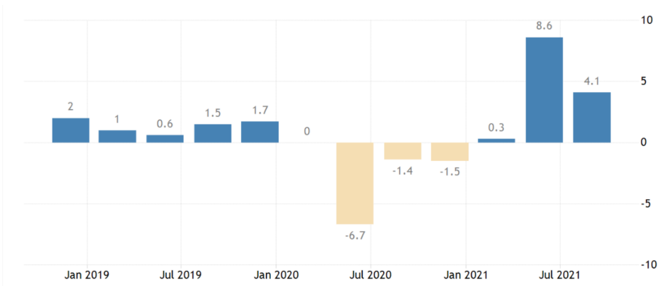
Basic Information

Real GDP (USD Billion)	752 (2020)
M2 (CHF Billion)	1,095 (Oct-21)
CPI	102 (Oct-21)
PPI	105 (Sep-21)
Con. Confidence	3.8 (Dec-21)
Currency	Swiss Franc (CHF)

Source: Trading Economics

Chart info

Figure 1: Annual GDP Growth (YoY)

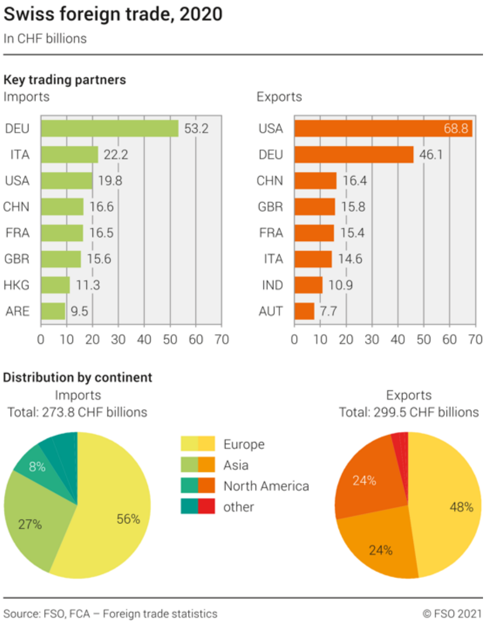


Source: Trading Economics, SECO

Overview of Switzerland

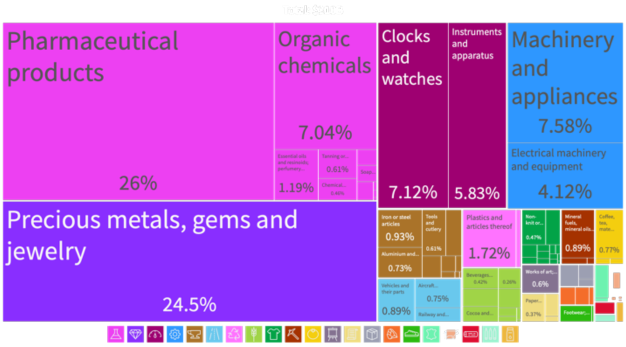
- Known for its high standard of living, Switzerland is a prosperous nation despite having a small population of 8.63 million people. Latest IMF estimates for 2021 has Switzerland in 18th place globally by size of nominal GDP and 2nd place by nominal GDP per capita. With a highly skilled workforce and free economy, Switzerland consistently ranks highly in economic ranking indexes, and was rated 1st both in the 2021 Global Innovation Index and the 2021 World Competitiveness Ranking. It was also ranked amongst the top 20 countries in the Human Capital Index, which gauges the forward productivity of an economy.
- The Swiss economy is primarily driven by its service industry (72%), of which financial services and tourism are the major constituents. The global Covid-19 travel and mobility restrictions have therefore hit the Swiss economy hard. The secondary driver of the Swiss economy is manufacturing (24.6%). With a trade-to-GDP ratio of 116% in 2020, Switzerland is a relatively open and trade-dependent economy.
- The European Union (EU) is Switzerland's main trading partner, whereas Switzerland is the EU's fourth largest trading partner (Fig. 2). While Switzerland is not a member of the EU, it does have access to the Common Market after it adopted a series of EU regulations. The Swiss dependence on trade with the EU is a source of concerns. In May 2021, the Swiss government terminated negotiations with the EU to upgrade existing trade relations, putting the future of EU-Switzerland trade relations in doubt. Switzerland mainly exports pharmaceuticals ($88.2 billion), precious metals, gems and jewellery ($86.2 billion) and organic chemicals ($25.4 billion) to its trading partners (Fig. 3).
- The CHF is considered a safe haven currency due to Switzerland's financial and economic stability as well as political neutrality. On top of this, as Switzerland has the world's lowest interest rates at -0.75%, the CHF is a funding currency for carry trades. The twin factors of stability and low interest rates causes market participants to retreat to the CHF in times of heightened volatility, uncertainty, and poor economic outlook.

Figure 2: Swiss Trading Partners



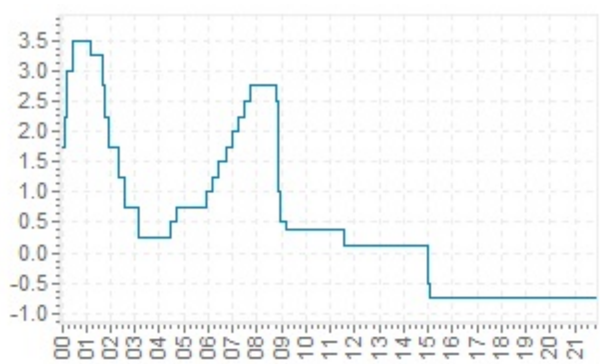
Source: Federal Statistical Office, Federal Customs Administration

Figure 3: Swiss Exports by Product



Source: The Observatory of Economic Complexity at MIT

Figure 4: SNB Policy Rate



Source: Global Rates

Summary of Events in the Past 6 Months

Fiscal Policy

- Fiscal policy in Switzerland has always been relatively conservative. The Swiss have a "debt brake" rule, in which over the medium term (an economic cycle), the federal budget must be balanced. Budget surpluses generated during economic expansion must be sufficient to pay off the deficits during economic contraction. However, due to the impact of Covid-19, the Swiss federal budget had been running a deficit for 2 years from 2020 to 2021. This is partly due to the government allocating CHF40 billion (as of June 2021 data) of spending on matters related to Covid, such as unemployment benefits and business support.
- In June 2021, the Swiss federal government approved the budget for 2022, which is projected to be in surplus by CHF600 million. As the pandemic is still ongoing, the government has allocated CHF1.2 billion to Covid-related expenditure in 2022, largely for the purchase of vaccines.
- To bring the fiscal position of Switzerland back in line with its debt brake rule, the government aims to run an annual budget surplus of CHF2.3 billion from 2023.

Monetary Policy

- The Swiss National Bank (SNB) conducts an in-depth monetary policy assessment at the end of every calendar quarter, where it makes its monetary policy decision and publishes its medium-term inflation forecast.
- During the June meeting, the SNB kept the interest rate at -0.75% (Fig. 4), and expressed its willingness to intervene in the FX markets as necessary to counter upward pressure on the Franc. Due to a rise in energy prices and supply chain bottlenecks, it forecasts inflation to be at 0.4% for 2021 and 0.6% for 2022 and 2023. This is well within the price stability criteria set by the SNB.
- During the September meeting, the SNB once again kept the interest rate at -0.75%. However, again due to energy price and supply chain bottlenecks, the projected inflation rate was revised upwards to 0.5% for 2021 and 0.7% for 2022. The inflation forecast for 2023 remained constant at 0.6%. Yet, these revised figures are still within the SNB's price stability criteria. As the inflation forecasts are made with the assumption that the SNB's policy rate remains at -0.75%, it is unlikely that the SNB will hike between now and 2023.
- In mid-December, the SNB will publish its monetary policy assessment again. Unlike the June and September meetings, during the December meeting, the SNB will include the end of 2024 in its projection horizon, which will provide market participants with a clearer idea of Swiss monetary policy going forward.

Geopolitical Events

- In June 2021, the G7 countries announced an agreement for a global minimum corporate tax rate of at least 15%. This will reduce the incentive for corporations to declare profits in low tax jurisdictions. Switzerland, as a low tax jurisdiction, will be negatively impacted by these plans. In response, the Swiss government has begun studying how it can use subsidies and other incentives to mitigate the impact of higher tax rates on Swiss-based corporations.
- In November 2021, China and Switzerland agreed to commence negotiations on upgrading and improving their Free Trade Agreement, which was ratified in 2013. China is Switzerland's third largest trading partner, after the EU and the United States.

Figure 5: Swiss Growth Forecasts (September)

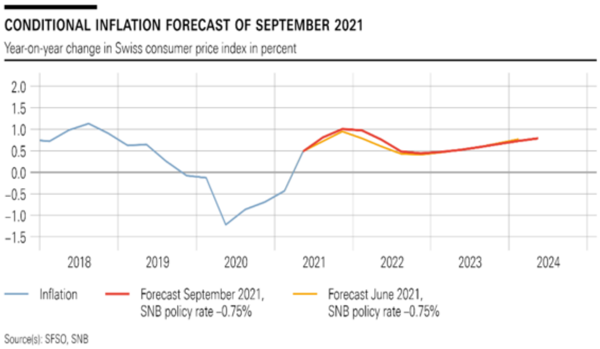
Forecasts Switzerland
Growth rates in % unless otherwise stated

	2021*		2022*		2023*
GDP, sport event adjusted	3.3	(3.2)	3.0	(3.4)	2.0
GDP	3.5	(3.4)	3.2	(3.6)	1.7
Private consumption	2.6	(2.6)	3.8	(4.2)	2.0
Government consumption	6.3	(6.4)	-1.5	(-2.5)	-1.9
Investment in construction	1.3	(1.8)	0.0	(0.4)	0.2
Investment in fixed assets and software	3.7	(4.5)	4.0	(4.3)	4.0
Exports	7.9	(6.3)	5.6	(6.7)	4.6
Imports	5.1	(4.8)	5.8	(6.3)	5.2
Employment in full time equivalents	0.5	(0.2)	1.5	(1.3)	0.9
Unemployment rate in %	3.0	(3.0)	2.4	(2.7)	2.3
Consumer price index	0.6	(0.5)	1.1	(0.8)	0.7

GDP and components: volumes, seasonally adjusted; foreign trade: excluding valuables.
* Forecasts by the Federal Expert Group on Business Cycles from 09.12.2021. Forecasts from 16.09.2021 in brackets.

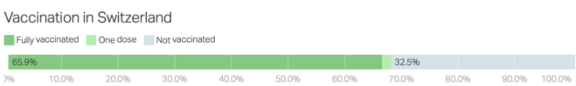
Source: SECO

Figure 6: SNB Inflation Forecast



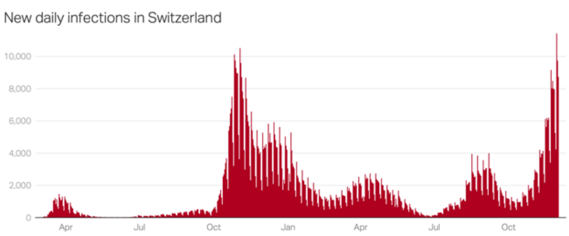
Source: SNB

Figure 7: Vaccination Rate in Switzerland



Source: Federal Office of Public Health

Figure 8: New daily infections in Switzerland



Source: Federal Office of Public Health

Rough Recovery

It's all about the money, money, money (and supply, and shipping containers, and…)

The Swiss economy was not insulated from the supply disruptions that plagued the world in 2021, hindering industrial production from reaching levels adequate to meet surging demand and the long list of backlogs. Since production capacities were reduced during the pandemic in 2020 in step with falling demand, it should not surprise us that supply is not elastic enough to adjust to demand recovery – especially when exacerbated by China's zero-Covid approach that is a hindrance for trade flow.

Progress brought about by ongoing vaccination programs, which improved labour mobility and ramped up factory production, was at least partially offset by the aforementioned delivery constraints. A SNB report indicated that around two-thirds of companies surveyed expressed delivery difficulties in 2Q'21 – as opposed to only a third of companies in 2Q'20. This could have wide-ranging repercussions within the supply chain and the broader economy, where production delays and stoppages could lead to producers trimming fat, therefore placing a strain on household income which trickles down to hamper consumer-induced economic growth.

On a relative basis however, Switzerland's recovery is still expected to outpace the rest of the Eurozone – including Germany – to return to pre-Covid levels (in GDP terms). Unsurprisingly, this has not come without a sharp jump in prices, which can mainly be attributed to energy base effects and rising raw material prices, and as a result can also be expected to normalise upon these base effects dissipating.

On the demand side, excess demand should gradually clear as global growth appears to have peaked. Moreover, SNB forecasts see inflation reaching 0.8% in Q2'24, remaining comfortably within their target range of "an annual inflation rate of less than 2%" (Fig. 6). Talk of stagflation is more or less also unwarranted in our view despite being a risk worth noting, as the Swiss franc's status as a safe haven currency should effectively hedge against rising prices in a low-growth environment.

Pandemic in Paradise

As of late November 2021, around 65.9% of the Swiss population have been fully vaccinated (Fig. 7). The Swiss government has been encouraging more citizens to get vaccinated, and has enacted regulation, effective from 13th September 2021, that only individuals with Covid certificates may access indoor spaces such as bars, restaurants and museums. These certificates can be obtained only if an individual is vaccinated, has recovered from Covid, or have had a positive antibody test. Additionally, all passengers on trains, trams, buses, railways and planes must be masked up at all times. However, Covid cases have risen rapidly since mid-Oct'21 and have made new highs (Fig. 8). As such, on 3rd December 2020, the Swiss government announced stronger anti-Covid measures, including a reduction of capacity for events and encouraging people to work from home. With the spread of the new Omicron variant, the Swiss government has also tightened travel restrictions to countries where the variant is present. These measures are set to dampen the recovery of the Swiss tourism industry, which contributed as much as 8.7% to the Swiss GDP prior to the pandemic.

SNB: Nothing to See Here, Move Along!

Based on inflation forecasts, we should expect an unchanged monetary policy environment at least till 2024, and a Swiss equity market that continues to be an underwhelming/ sub-optimal environment for risk-tolerant investors looking for alpha opportunities.

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

Despite rates being well below zero (SNB policy rate is the world's lowest at -0.75%), the SNB has made it clear that it is willing to stomach the potential negative side effects that come with record low rates (e.g. rising house prices in the long run) and implement macroprudential measures where necessary – including currency market interventions, which have been one of its hallmark policy tools. These measures would be necessitated if franc appreciation lowers inflation forecasts and strengthens the currency, which has already been widely deemed as overvalued.

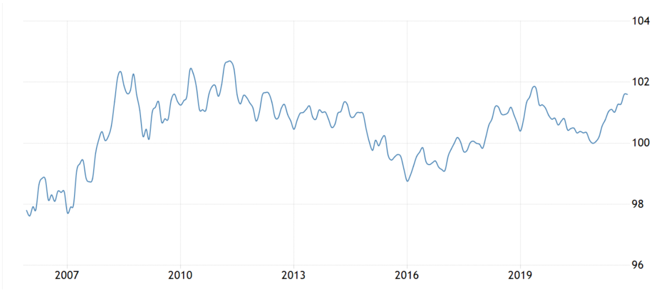
The SNB interest rate has been set at -0.75% since January 2015 and is unlikely to be raised in the foreseeable future due to persistent disinflationary pressures – Swiss CPI has not exceeded 1.0% since 2008 (Fig. 9). Given the moderately negative Swiss interest rates, there is little room for further rate cuts by the SNB - it has gone almost as low as it can. This leaves FX as the main channel for further SNB policy easing.

A key determinant of SNB monetary policy is its rate differential against the ECB, which means that its hiking cycle is closely watched in tandem with the ECB's. Current market pricing suggests that the SNB should hike well ahead of the ECB. As unlikely as it may be, one scenario that we see may force the SNB's hand to hike earlier than the ECB is a significant depreciation of the Swiss franc – that drives inflation beyond the SNB's 2% target.

Another of its policy tools, the tiering multiplier for sight deposits, was also left unchanged in 2021 (77% of sight deposits are exempted from negative rates). Such deposits have stabilised since 2Q'20 (Fig. 10) on the back of minimal SNB forex interventions (Fig. 11), signalling as a whole that money market conditions are roughly in line with expectations.

Since peaking around 1.11 in March 2021, the EUR/CHF FX rate, which is closely monitored by the SNB, has declined to approximately 1.04. This decline can be attributed to a decline in the value of the Euro as Eurozone yields fell as a result of ECB QE programs as well as a less optimistic global growth outlook. Traditionally, the 1.05 level in EUR/CHF has been defended by the SNB. However, as mentioned above, sight

Figure 9: Switzerland CPI (since 2005)

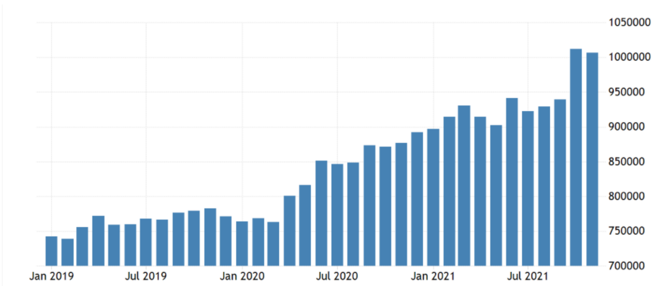


Source: Trading Economics

Figure 10: Sight Deposits of Domestic Swiss banks

Source: Bloomberg

Figure 11: Switzerland's Foreign Reserve Holdings



Source: Trading Economics

deposits at the SNB remain steady, indicating that there were no major SNB FX intervention efforts recently. Going forward, it is key to closely monitor sight deposits level for signs of SNB intervention, which could indicate that the pain threshold of the SNB has been reached.

Swiss-EU Relations: Freezing like the Alps?

On the geopolitical front, a key development to watch is the Swiss-EU relationship, which took somewhat of a hit after a long-running negotiation on an Institutional Framework Agreement (IFA) – a platform for implementing improvements to Swiss firms' access to the EU market – broke down in May'21, presenting an important developing headwind for the two trading partners' symbiotic relationship. The IFA was meant to consolidate the immense web of over 100 agreements and treaties that govern the Swiss-EU relationship.

The Swiss government was opposed to EU demands in three particular areas – the protection of Swiss wages, rules regarding state aid for firms, and EU citizens' rights, including the right of EU citizens to access Swiss welfare.

The European Commission has warned that the existing deals between EU and Switzerland were "not up to speed", and there is a real danger that EU-Swiss deals may lapse. Indeed, a deal on medical technology products has already lapsed. According the Swiss MedTech organisation, the lapsing of this deal will cost the Swiss medical technology industry CHF114 million in 2021 alone.

In November 2021, the European Commission indicated that both the EU and Switzerland were increasing efforts to re-establishing negotiations on the IFA. While this is a welcome development, there is not much optimism that the IFA can be concluded before 2023 (when the Swiss federal elections will be held), as politicians and parties will both be keen to avoid this prickly topic. Meanwhile, we do not expect significant changes to the EU-Swiss relationship, as the close integration of both economies means that both sides will be keen to maintain cordial ties.

Figure 12: EURCHF Weekly Chart

Source: Trading View

Figure 13: EURCHF Daily Chart

Source: Trading View

Figure 14: EURCHF Monthly Chart

Trade Idea: Long EURCHF

As the ECB tapers and eventually brings the PEPP to a halt, collateral shortage of Euro-denominated securities should be relieved with an increase in net supply of EGBs. This should reduce downward pressure on the value of the Euro. Furthermore, SNB policy is to prevent excessive appreciation of the Franc, which, through trade channels, dampens Swiss economic growth and lowers the general price level, preventing the SNB from achieving its objective of price stability. While the SNB has yet to intervene, we think that the SNB may soon be running out of patience to act.

SNB governing board member Andrea Maechler has reiterated to the media during a November 27 interview that the SNB is "always ready to intervene in foreign exchange markets if needed". This comes during a period of protracted CHF strength, where CHF traders are focusing on whether the SNB will intervene to prevent the EUR/CHF from depreciating past 1.03 - 1.05.

As such, we recommend a close monitoring of the extent of QE tapering by the ECB and the level of Swiss sight deposits. As the SNB does not disclose the precise EUR/CHF FX rate which warrants intervention, traders will be wise to average into and build up a long position in the EUR/CHF progressively.

Technical Analysis

On the monthly chart (Fig. 14), EUR/CHF is approaching a key multi-year support level between 1.02 – 1.03 which was last breached when the SNB removed the EUR/CHF peg back in 2015. This is the also the last major support level before parity at 1.00. Given that the EUR has become very oversold against a number of currencies on a weekly basis, a multi-week upward correction in the EUR/CHF rate is highly likely. We recommend that traders scale into a long position and take profit at the March 2021 peak of 1.11.

Trade

Long EUR/CHF: conditional on no significant changes in either ECB or SNB policy.

Entry: 1.00-1.04
Take Profit: 1.11
Stop Loss: 0.98-0.99
Risk Reward Ratio: ~2.25 (Assuming an average position of 1.02)

NUS INVESTMENT SOCIETY

Global Macro Department – United Kingdom (UNDERWEIGHT)

Date: 15th December 2021

Analysts

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Global Macro Analyst
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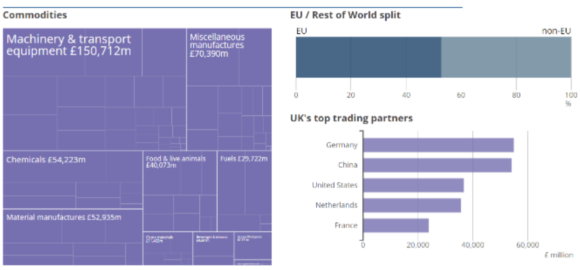
Basic Information

Real GDP(US$)	2.708 trillion USD
M2	2961077 GBP million
Inflation rate	3.8%
CPI (based on 2010)	113.6
PPI (based on 2010)	116.6
Con. Confidence	-14.0%
Unemployment	4.3%
Currency	Pound Sterling (GBP)

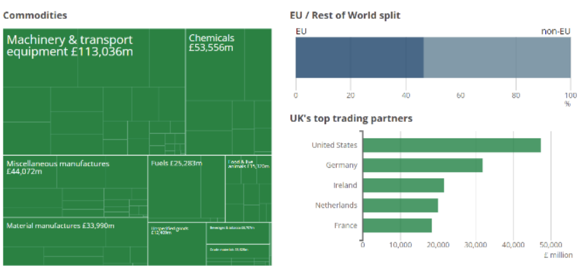
Chart info

Figure 1: UK's imports in 2020



Sources: UK Trade Statistics, Office for National Statistics

Figure 2: UK's exports in 2020



Sources: UK Trade Statistics, Office for National Statistics

Figure 3: Recovery from COVID-19

Overview of the United Kingdom

The United Kingdom comprises England, Scotland, Wales, and Northern Ireland, and uses the pound sterling as its national currency. It is the fifth-largest national economy in the world with a GDP of 2.7 USD billion in 2020. The economy is mainly driven by the services sector, which constitutes 72.8% of its GDP. The industry and agricultural sectors make up 16.9% and 0.6% of the GDP respectively.

Trade plays a pivotal role in the UK economy, making up 55.0% of its GDP in 2020. Both exports and imports each contributed 27.0% to its GDP. Top imported goods include cars, medicinal & pharmaceutical products, clothing, capital telecoms & sound equipment, and capital office machinery, while the top exports comprised intermediate mechanical power generators, crude oil, and non-ferrous metals.

Despite its withdrawal from the European Union single market, the EU remains its largest commercial partner, with transactions accounting for 49% of the country's exports and 52.0% of its imports in 2020.

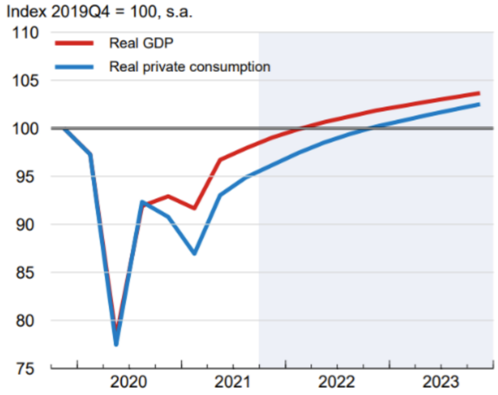
Since the pandemic broke out, the UK's economic recovery has been slow but set to continue. This is supported by the government's continued efforts to vaccinate the population. As of 2nd December 2021, 69.0% of the population has been fully vaccinated. OECD expects the economy to return to pre-Covid-19 levels at the beginning of 2022. Output is projected to rise in 2021, and growth is expected to moderate in the coming two years. This economic growth will be mainly driven by consumption expenditure. Business investment will improve but will still be impeded by the uncertain climate. As post-Brexit continues to work through its border regulations, we can expect border costs to increase. Unemployment will continue to decline. Inflation will continue increasing as energy and commodity prices rise and supply shortages persist. The bank estimates inflation to peak at 4.9% in the first half of 2022 and then fall to its 2.0% target at the end of 2023.

Summary Of Events In The Past 6 Months

- Bank of England has maintained the bank rate at a historic low of 0.1% since March 2020.

- In September, the government-funded Coronavirus Job Retention Scheme which supported 11.6 million jobs ended. Self-employed worker grants also ceased, with Value-Added Tax announced to increase in hospitality, hotel, and leisure sectors. The £20 weekly top-up to Universal Credit, a government-funded benefit program that supports over five million people was also ended.

- Widespread labour shortages and supply chain disruptions were experienced across Britain's economy. This was acutely evident in the lack of qualified heavy-goods drivers, leading to fuel shortages and shortages of food essentials.



Source: OECD Economic Outlook

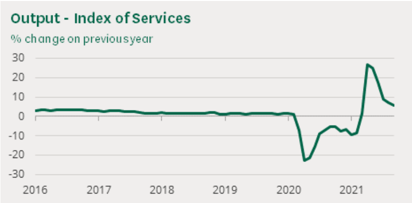
- Soaring gas prices have left many gas suppliers shutting down as they could not shoulder the loss-making price levels that could not be passed onto households due to the energy price cap set by the government. Firms in other sectors have not been spared either. Large steelmakers and manufacturers which are highly vulnerable to energy prices have faced significant financial strains. Fertiliser companies have also reported shutting down in the upcoming winter, and this may result in knock-on effects in the food industry.

- The UK announced that the tax surcharge on bank profits will be reduced by more than 60.0% from 8.0% to 3.0% from April 2021 to keep London competitive after Brexit.

- Following the sharp 10.0% contraction of its economy last year, the UK is set to grow 6.5% in 2021 according to the Office for Budget Responsibility. The projected growth leaves the UK on course to achieve its fastest growth in over two decades.

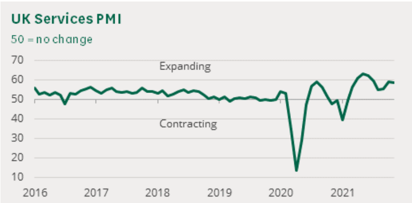
- The discovery of a new variant has affected business and consumer confidence ahead of Christmas, one of the most profitable seasons, with the service industry reporting a noticeable increase in cancellations.

Figure 4: UK Output – Index of Services



Source: UK House of Commons

Figure 5: UK Services PMI

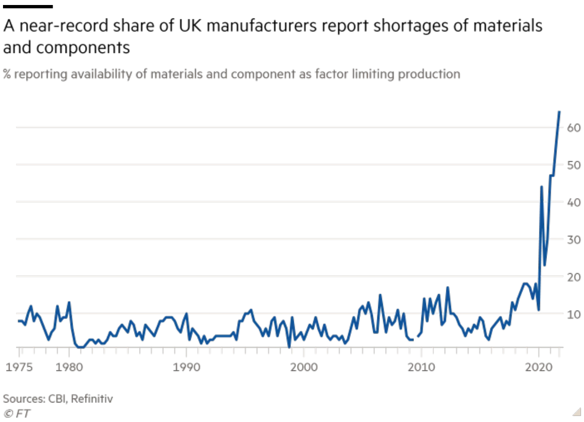


Source: UK House of Commons

Figure 6: CPI inflation and its drivers

Source: Standard & Poor's Financial Services LLC

Figure 7: Acute UK Manufacturing Shortage



Source: CBI, Refinitiv

Economic Recovery From COVID-19

The service industries which spearhead Britain's economy have increased output across 2021. In the three months leading to September, the economy experienced a 7.2% increase year-on-year. Similarly, the Purchasing Managers' Index in the services sector experienced a general increase, with November's flash estimate being 58.6. Although there was a slight decline from 59.1 in October, it remains an indication of a strong expansion. Demand and sales volumes have also stayed robust, despite rising input costs.

The economy is also experiencing strong wage growth of approximately 5.9%. But with base and compositional effects factored in, this wage rise is expected to remain benign.

However, growing inflation pressures have been weighing on the British market as well. With record-level prices of energy and rising prices in transportation and materials amidst global supply chain bottlenecks, producer input and output prices have seen an increase of 11.0% and 6.0% year-on-year respectively. These prices are likely to be passed onto consumers, pushing inflation rates even higher.

The compounding effects of these issues has affected consumer confidence as the economy battles with a labour market crisis, energy crunch, high inflation, and an uncertain COVID-19 climate – all at the same time. With the new discovery of the Omicron variant, we can expect consumer confidence to fall further in December with the tightening of border controls worldwide and heightened cautiousness of the market which may dampen demand and spending on goods and services.

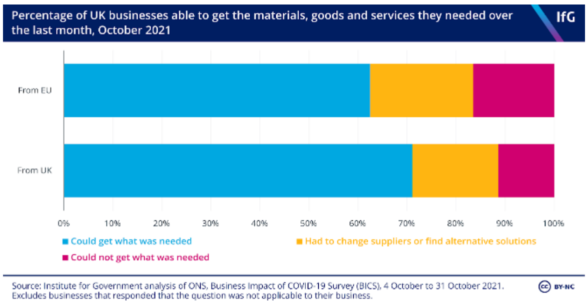
Supply-chain Disruptions

British manufacturers have cited rising costs due to higher material costs from labour shortages, and a series of serious global supply challenges hampering their ability to meet strong demand. A third of them have expressed concerns about staff shortage affecting future output, with two in five companies worried about a lack of skilled labour – which are the highest level recorded and highest level since 1974, respectively. Manufacturing cost growth has been rapidly increasing, fuelling further price pressures. Currently, the average domestic and export prices are growing at their fastest rate since 1980 and 2011 respectively. These compounding effects will likely hinder the ability of the manufacturing industry to reach pre-COVID levels in 2018, hampering the promise of a "V-shaped" economic recovery.

The UK business output growth has also fallen to the lowest level since March last year during the lockdown. As economies reopen and demand returns from the pandemic slump, the UK businesses have found themselves grappling with persistent supply problems that are hindering them from maximizing the full advantage of the recovering global economy. This, coupled with increasing costs especially in the energy sector and the domestic labour shortage, has slowed growth further.

17.0% of businesses have also been unable to receive goods from the EU, while 11.0% could not receive goods from within the UK. A survey carried out by the Confederation of British Industry has also shown

Figure 8: Overview of firms' ability to get resources



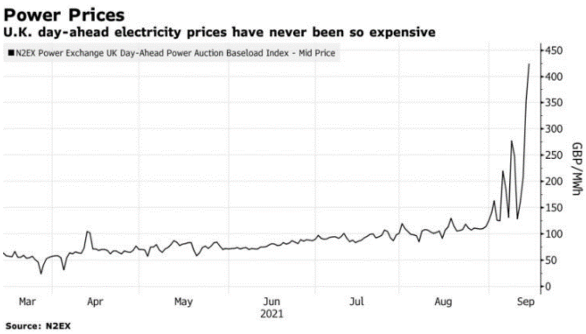
Source: Institute for Government analysis of ONS

that inventory levels of firms have reached the lowest levels since 1983. One persistent and acute shortage faced amongst the manufacturing industry is computer chips, heavily impacting car producers both in the UK and globally. BDO's manufacturing index has also fallen by two points to 97, nearing the 95-mark that represents declining output. Manpower shortage in the service industry, which dominates the economy, has resulted in a slowdown in the sector.

Widespread shortages have also been experienced in petrol and supermarket supplies, due to the lack of qualified heavy goods drivers. Following the pandemic, Brexit, and tax changes, Britain found itself caught in a nationwide shortfall of about 100,000 essential deliverers. Many have returned home to the EU following Brexit, and border restrictions make it hard to employ overseas manpower. Giants like Nestle, the world's largest producer of dairy products, and Arla, which supplies milk to all major UK supermarkets, have been forced to cut deliveries due to insufficient qualified drivers. Pig farmers in the poultry industry have also been hit severely due to manpower shortages in abattoirs. With slaughter-ready pigs waiting to be sent to butchers and the lack of trained staff to prepare these pigs into food, the industry faces the risk of wastage as pigs are killed and sent to landfills instead. Amongst households, 37.0% of surveyors in the Office of National Statistics survey revealed that they could not buy fuel for their vehicles during the peak of the petrol crisis in October. Similarly, around 17.0% faced difficulties in obtaining certain grocery products due to decreased frequency of deliveries.

Energy Crunch

Figure 9: UK Power Prices



Source: N2EX

As economies worldwide reopen and resume their recovery to normalcy, demand for resources has spiked. At the center of this energy crunch is natural gas, the pivotal resource that generates electricity for factories and homes and the transition away from highly polluting coal in the global green movement.

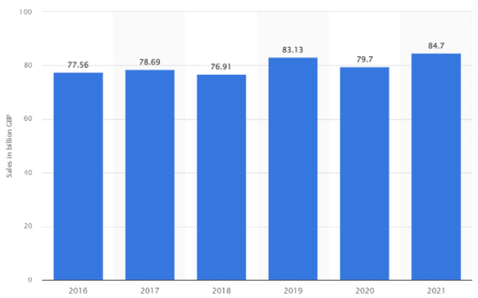
This unexpected surge in demand has led to an acute shortage in the energy industry, sending its prices skyrocketing about sixfold. As the major season of gas consumption – winter – approaches, nations across Asia, Europe, and North America, have been scrambling to outbid each other to top up their fuel storage to tide through the season. Coupled with the world's largest gas importer, China, snapping up gases to fuel power plants and reduce carbon emissions, precious gas supplies are effectively being drawn away from Europe.

This consistent upward pressure has been passed onto households and businesses across the UK as they face a significant rise in energy bills and operating costs. As businesses nationwide struggle to stay afloat, several UK factories have been forced to shut down or halt production. Those badly hit include companies with processes that are heavily reliant on electricity, e.g., fertilizer, steel, and glassmakers. A prime example is CF Industries Holdings Inc., a major UK fertilizer maker, which had to halt production in two plants due to high natural gas prices. These disruptions reveal the negative repercussions of the energy crunch which will eventually spill over into the food and goods industry, and drive inflation as firms pass on the increase in production costs. Moreover, the energy crunch has left a reported 30 energy companies ceasing operations in the UK after failing to deliver gas to clients at the promised price level that is now loss-making due to the high wholesale prices.

Compared to other economies, the UK remains acutely vulnerable to the energy crunch with natural gases accounting for 40.0% of its country's electricity. This can be attributed to its prior commitments to the Green movement, which pledges to cut greenhouse emissions to curb global warming. The phasing out of coal in power generation and the paradigm shift towards renewable energy like offshore wind has unexpectedly landed them in a precarious position of over-dependence on a single energy resource. Moreover, wind generation, which accounts for 20.0% of their power, has been unusually weak in recent months. Evidently, the UK has fallen through the gaps amidst its shift towards a clean economy.

In the short run, we can expect the energy prices to increase further as winter approaches and demand continues to increase. However, the UK's response to this crisis will be of paramount importance to overcoming this problem. If it remains slow in diversifying its energy sources or is unable to bridge the gap between its existing system and its renewable energy models, the UK may face prolonged vulnerability with these unstable prices.

Figure 10: Christmas sales in UK



Source: Statista

Omicron Variant

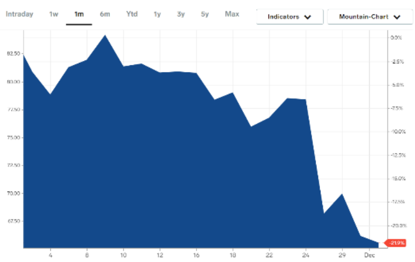
The discovery of the Omicron variant just weeks before Christmas, the largest festive season in Britain, has led to an increase in cancellations and postponement of bookings in the F&B and hospitality industries. While such reports are not widespread as of now, businesses remain wary as they await to see the true severity of the variant.

Despite so, the heightened alert has dampened the confidence of waning businesses who have been hoping to improve sales during this crucial season to offset shortfalls throughout the year. In 2020, the total value of Christmas sales in GDP fell by 4.1% to 3.43 billion GBP from 2019 due to Covid-19. While research has projected the sales to increase back to pre-Covid levels in 2021, such hopes have been quelled with the Omicron variant. The potential loss of a second consecutive Christmas season could spell disaster for many businesses as some may fall back into loss-making as government relief packages have also fallen away.

As of 4th November 2021, the forecasted sales in GDP could reach up to 84.7 billion GBP, up from pre-Covid levels in 2019. This highlights the importance of the season in enabling businesses to regain financial foothold and recoup the losses experienced over the tumultuous two years. However, the threat of Omicron continues to loom ahead.

Evidently, more studies must be drawn on the variant to assess its severity, which will subsequently affect consumer confidence and the potential of Britain's economy to resume the path to normalcy.

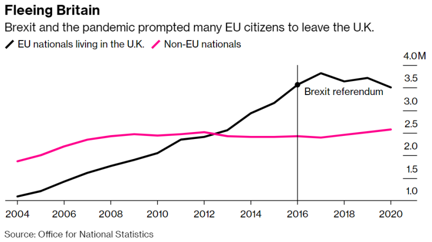
Figure 11: Oil(WTI) Commodity Prices



Source: Business Insider

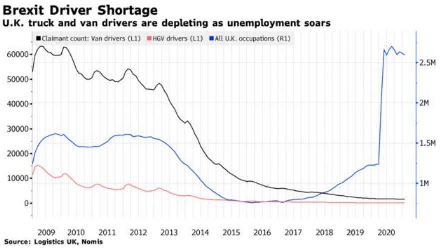
As the Omicron variant emerges, the financial market has been spooked by the heightened uncertainty. This is reflected in the oil prices, which were sent tumbling down after investors' worries about oil demand. This posts the biggest monthly fall in oil in 20 months. While this reflects the drop in market sentiment due to the threat of yet another wave, this fall may provide some respite for firms that have been battling with surging operational costs. However, one has to factor in the sentiment of consumers as well as the possibility of a lockdown or tightening of measures if the variant proves deadly will negatively affect demand, which may slow the economy once again.

Figure 12: EU citizens leaving UK



Source: Office for National Statistics

Figure 13: Brexit Driver Shortage



Source: Logistics UK, Nomis

Labour Market

An estimated 200,000 EU citizens left the UK when free movement across the borders for EU workers ceased. This led to an acute labour shortage in industries like accommodation and food services that are heavily reliant on these workers. Exacerbated by the unavailability of overseas hires due to tightened travel restrictions, businesses face a serious risk of a sharp shortage.

Moreover, hundreds of thousands of British workers, the highest ever recorded, have left the workforce to return to take classes during the pandemic. Many have also chosen less tedious jobs with more flexibility and better benefits instead, leading to a fall in workers in industries like hospitality.

In October, the UK experienced a severe gasoline shortage in part due to the shortage of qualified heavy goods truck drivers to transport fuel to the gas station after its European drivers returned home during the lockdown. An estimated one-third of Britain's UK logistics will face trucker shortages, posing a significant difficulty for them to recover from the pandemic. It will be highly unlikely for these drivers to return due to stricter visa regulations post-Brexit, underscoring a prolonged shortage.

Unemployment rose by 150,000 when the government-funded furlough scheme ended. As a record 1.3 million vacancies were opened in the labour market, experts believe that many furloughed could attain jobs relatively easily.

Studies by Her Majesty's Revenue and Customs and Office of National Statistics has shown that 500,500 of the furloughed workers have found alternative part-time jobs, while 65.0% of those furloughed returned to work on the same hours. Only 3.0% were made redundant.

However, labour shortage persisted due to the apparent mismatch between the type of jobs available and the skills possessed by the unemployed. Analysts have remained wary that such mismatches would not be resolved quickly. Furthermore, the economic recovery has revealed signs of slowing down, impeding the process of retraining the workers further. Hence, these furloughed workers will not be the end solution to alleviate the labour market crisis Britain is facing.

We can expect the labour shortage crisis to persist unless Britain finds a solution to re-introduce manpower from abroad or the European Union. This could lead to a further increase in inflation for goods and services since higher operational costs are passed onto consumers.

Brexit Trade Relations

The economic repercussions of Britain's exit from the EU single market are already reflected in the rise in inflation. These can be attributed to the increased trade and immigration restrictions that have hindered the cross-border movement of workers and slowed down the transportation of crucial industrial materials. This effect is exacerbated by the onset of the pandemic that has led to tightened border controls.

The UK has pumped in 1.4 billion GBP to ease transportation of goods across the Brexit border. This included the cost of building border facilities and providing support for business in Northern Ireland. Despite so, trade between the UK and its biggest trade partner in the second quarter fell by 15.0% compared to 2018 figures. On the other hand, its trade with the world only rose by 1.0%.

These border costs are expected to increase further as the post-Brexit border regulations have not been fully rolled out. Currently, customs declarations amount to about 30 pounds each, accumulatively adding billions in operating costs for firms trading between these two regions.

As such, we may expect businesses to face increasing border costs, which may deter them from operating between the UK and the EU, if significant enough.

While post-Brexit UK remains acutely dependent on the EU market, it has been trying to establish stable trade relations with countries to mitigate the decline in trade with the European bloc but has been largely unsuccessful in regaining a foothold. Britain has yet to finalize a trade agreement with the bloc.

Although some agreements have been made with Australia and New Zealand, they have not been formalized. Moreover, the government has forecasted that the benefits from these deals will be significantly smaller than the economic damage from leaving the bloc.

Following the concerns of the triggering of Article 16's emergency clause by Britain, the U.S. announced that it will delay its UK trade deal. This entails that the 25.0% and 10.0% tariffs on UK steel and aluminium imposed under the former Trump administration on the European Union in 2018 will remain for Britain. Although they were withdrawn in October 2021 for the EU, they remain in place for post-Brexit Britain.

The lingering uncertainty in the atmosphere surrounding Britain's trading scene will be here to stay until sufficient ground is gained after the UK and the EU come to an agreement to stabilise trade relations. Meanwhile, the ability of the UK's economy to regain foothold and establish secure trade deals with other countries to overcome the shortfall from Brexit will be key in determining Britain's economic outlook and general market sentiment.

Northern Ireland Protocol

Article 16 of the Brexit deal allows safeguard measures to be executed if the protocol is causing severe and persistent "economic, societal or environmental difficulties", effectively acting as an emergency brake to suspend sections in the agreement if necessary.

Currently, Northern Ireland is in the EU single market with goods flowing freely between the Republic of Ireland and Northern Ireland. Conversely, specific goods e.g., meat and eggs must undergo screening as they enter North Ireland from Great Britain.

However, the UK is now proposing for goods conforming to either EU or UK standards to circulate freely in Northern Ireland and remove the European Commission and the European Court of Justice's roles in overseeing the deal. Studies have revealed that up to £3.5bn worth of

British exports, a sizeable 10.0% of the exports, have had EU tariffs applied despite the zero tariffs Brexit deal due to the complex process of claiming zero tariffs. Hence, this proposal could create a backdoor into the EU single market without incurring tariffs, significantly alleviating firms' costs.

Although renegotiation has been dismissed, the EU has proposed to reduce security scrutiny on food, halve paperwork, and will consider enabling medicinal trade to continue. However, they are also pushing for additional security checks and access to real-time UK trade data to stop Great Britain's produces from crossing into the Republic of Ireland.

This unabating tension from negotiations has been exacerbated by Britain's threats to trigger Article 16. The market will have to see how the negotiations pend out. The UK's fragile recovery will be crucially dependent on them. If negotiations break down, business confidence will fall amidst the uncertainty and undermine the pound, eroding real incomes and worsening its inflation. If a trade war ensues, we can expect tariffs and transportation backlogs to further inflate prices. These will all weigh negatively on the UK's economic outlook.

Bank Of England

Monetary Policy
On 2nd November 2021, BOE's Monetary Policy Committee announced it will keep bank rates at 0.1% and maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at 20 billion GBP.

BOE will continue its current UK government bond purchases programme, financed by the issuance of central bank reserves. The stock target of these government bond purchases will remain at 875 billion GBP, with the total target stock of asset purchases at 895 billion GBP.

Despite so, the MPC maintains its hawkish stance and will subsequently increase Bank Rate over the months to return CPI inflation to its 2.0% target if the market remains broadly in line with their central projections.

Fiscal Policy

End of COVID-19 Relief Measures
As the Coronavirus Job Retention Scheme, which supported 11.6 million jobs, ended in end-September, over a million jobs were estimated to have been furloughed. This was significantly more than BOE's forecasted figure in August.

Grants for self-employed workers also ended, and VAT rates for goods and services were increased for hospitality, hotel, and leisure attractions to 12.5%.

The government also ended the extra £20 Universal Credit benefit, which supports over 5 million people.

These withdrawals of subsidies and increases in taxes may dampen consumption but a detailed analysis of its effects in the fourth quarter must be studied before weighing their actual impacts.

Introduction of subsidies

Amidst the uncertain economic recovery, the UK introduced a 500-million-pound fund to alleviate the rising living costs of households battling the rising energy prices, higher inflation, and cuts to the aforementioned benefits.

Figure 14: GBPJPY Chart

Source: Trading View

Figure 15: JPX Chart

Source: Trading View

Trade Idea: Short GBPJPY

Following the global energy crunch, the GBPJPY experienced a decrease from end October and continues in its decline till today.

The United Kingdom has been most badly hit by the energy crunch due to its overreliance on a gas-powered economy. With over half of the nation's city generated by gas-operated power plants, the UK has seen its energy market collapsing with its 25th UK supplier going bust in just three months. This paints a bleak future outlook with a cold winter looming ahead and record-low storage levels. Businesses and experts have already raised concerns of possible industrial blackouts. With the latest suspension of certification of Nord Stream 2, hopes of a respite in the gas market have been dashed and gas prices have soared further.

Moreover, the acute labour shortages in Britain will not be expected to improve in light of the new Omicron variant which has tightened border regulations around the world and made overseas hiring and increasing the inflow of European workers via post-Brexit visas even less feasible. This could prolong the current shortage and lead to even greater disruptions in the near future.

Furthermore, with the rising uncertainty surrounding Omicron, we can expect volatility to increase in the currency market. Since the Japanese Yen is a safe-haven currency, we expect it to appreciate.

All these point towards a downward trend of GBPJPY.

<u>Technical Analysis</u>

GBPJPY has trending downwards since end October. This is also reflected in the downward sloping Moving Average Convergence Divergence indicator.

Moreover, the JPX (Japan Yen Index) is at the lower of its Bollinger bands. As such, we expect the Yen to appreciate in a mean-reversion move, which supports the downward trend of the currency pair.

We would initiate a short at 150.600. We will set out the stop loss at the top of the channel at 150.900 and take profit at the bottom at 149.980.

Entry: 150.600
Take Profit: 149.980
Stop Loss: 150.900
Risk Reward Ratio: 2.067

NUS INVESTMENT SOCIETY

Global Macro Department – Russia (OVERWEIGHT)

Date: 15th December 2021

Analysts

Vun Jia Hui Samantha
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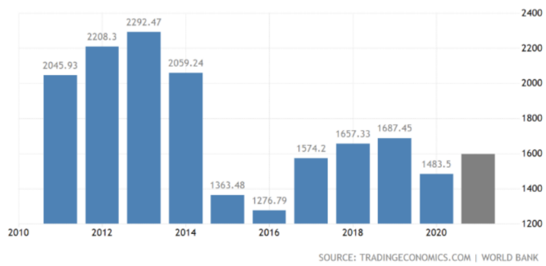
Basic Information

Real GDP(US$)	1.483 trillion USD
M2	60813.70 RUB billion
Core inflation rate	8%
CPI (based on 2010)	203,5
PPI (based on 2010)	247,7
Con. Confidence	-19%
Currency	Russian Ruble (₽)

Chart info

Figure 1: Russian GDP



Sources: Trading Economics, World Bank

Overview Of Sector

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

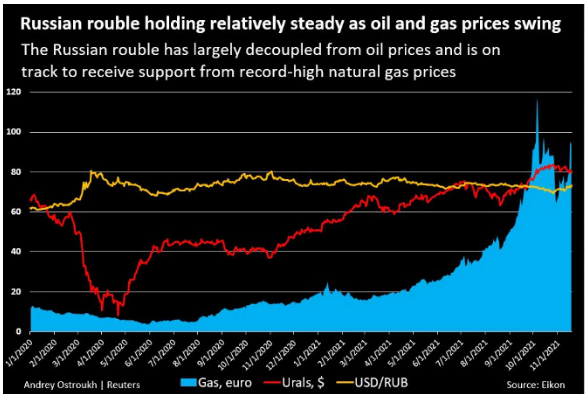
Russia's economy is largely driven by the service sector that accounts for 62% of the GDP and employs 67% of the population, followed by the industrial sector that contributes 32% of the GDP. Crucial sectors of the service industry are comprised of financial services, communications, travel and tourism, advertising, marketing and sales, real estate, healthcare, and social services, art and culture, IT services, wholesale, and retail trade and catering. The industrial sector consists of construction, electricity, mining, manufacturing, water, and gas and currently employs 27% of the population.

As of 2020, exports and imports accounted for 26% and 21% of Russia's GDP respectively. Overall, trade constitutes 46% of the GDP.

Summary Of Events In The Past 6 Months

- Russia reveals plans to remove dollar assets from the National Wealth Fund as they continue to push forth with de-dollarization efforts.
- The Nord Stream 2 pipeline was officially completed on 10th September 2021.
- On 22nd October 2021, the Central Bank of Russia raised its key rate for the sixth time in 2021 by 75 bps to 7.50% with a forecast of inflation by the end of the year set between 7.40–7.90%.
- Germany suspends the approval of the Nord Stream 2 pipeline, dashing hopes that it would relieve the energy crunch in the shorter term. This led to a spike in gas prices once again.
- Russia and Ukrainian relations sour further as satellite images reveal a Russian military build-up near the borders, raising suspicions of potential invasions by the former.

Figure 2: Russian Ruble against oil and gas prices



Source: Eikon

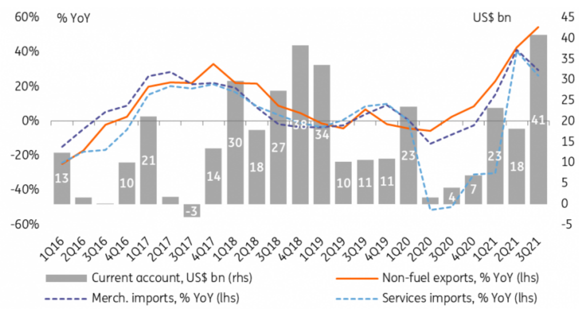
Economic Recovery From Covid-19

Russia's natural endowment of important resources like oil, natural gas, timber, and precious metals has enabled the country to capitalize on these resources. The fuel and energy complex, Russia's main exports, play a crucial role in the Russian economy.

This leaves Russia's economy vulnerable to the volatile changes in oil and natural gas amidst the ongoing pandemic and energy crunch. This strong correlation means that any fluctuations in oil and natural gas prices will have a pronounced effect on the Russian economy. When oil prices dipped at the beginning of the pandemic as economies worldwide went into shutdown, Russia experienced a contraction. Conversely, the high demand for oil and natural gases has sent their prices skyrocketing in 2021 as economies regained their momentum. These record-high prices for natural gas have largely benefited the Ruble since this revenue is not absorbed by the National Wealth Fund to the degree of revenues from oil. This is due to the budget rule set aside in 2017 which necessitated additional energy revenues to be channelled to the National Wealth Fund when oil prices increase beyond $43.40 per barrel. This helps to minimize the budget deficit and protect the Ruble from fluctuations in oil prices.

This leaves gas prices more likely to affect the exchange rate. In recent months, the high gas prices have supported the Ruble at 72-73 as of mid-November. Moreover, this increased revenue has increased Russia's current account surplus by over three times to $94.4 billion from January to October 2021.

Figure 3: Current account outperformed expectations with strong exports and restrained imports



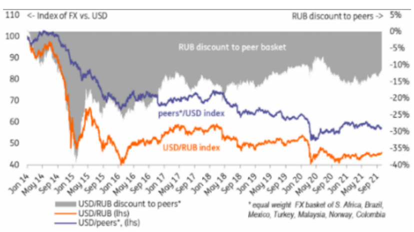
Source: Bank of Russia, ING

Positive Current Account performance

In the third quarter, Russia experienced its largest-ever current account quarterly surplus of US$40.8bn, well exceeding initial expectations of US$32bn and meeting the top consensus range.

- Non-fuel export growth accelerated to 55% YoY with exporters of metals, select fertilizers, and agriculture products experiencing higher demand amidst the stronger pricing environment.
- Meanwhile, import growth on goods and services was kept restrained at 30% year-on-year due to limited outward tourism and the moderation of merchandise imports after a very strong spike in the previous quarter.
- Despite this, the import growth appears elevated relative to the exchange rate performance. This can be attributed to the substitution of foreign travel with import consumption, alongside some recovery in local investment activity.
- Fuel made up 48% of Russia's export proceeds in 9M21, greatly benefitting from the high demands in a better pricing environment and volumes. With the likely seasonal increase in gas export volumes as winter approaches in the fourth quarter, alongside the easing of OPEC+ restrictions, we can expect Russian exports to increase further.

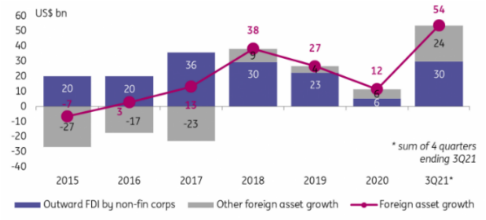
Figure 4: Strong Russian Ruble against its peers in third quarter



Source: Refinitiv, ING

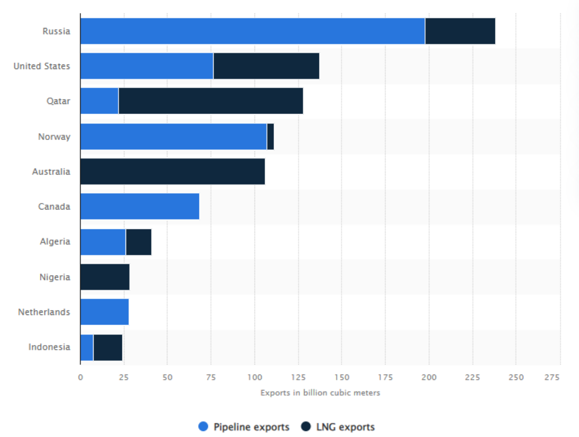
These positive current account surpluses and the high prices of fuel in the market have supported the Ruble well, enabling it to strengthen and appreciate against its peer currencies.

Figure 5: Rise in private capital outflow



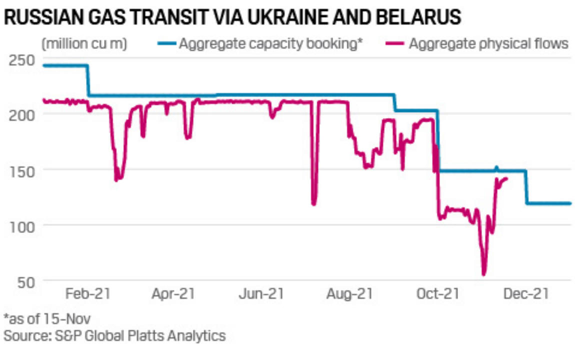
Source: Bank of Russia, ING

Figure 6: Top gas exporting countries in 2020



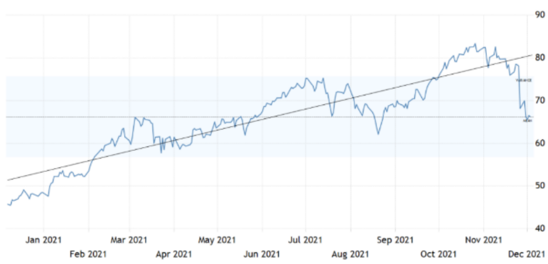
Source: Statista

Figure 7: Russian Gas Flows



Source: S&P Global Platts Analytics

Figure 8: Crude Oil Prices



Source: Trading Economics

Private capital outflow drags

However, the increase in private capital outflows has resulted in a major drag on the Ruble. These leakages have picked up to US$58.9bn for 9M21 after a brief improvement in 2020. Evidently, the capital outflow structure has resumed to the focus of accumulating foreign assets. This will limit the Ruble's appreciation in the medium term, keeping the currency undervalued.

Energy Crunch

As the world's leading exporter of gas and major exporters of oil and coal, Russia is poised to benefit from this energy crunch financially. With global economies opening up and gaining momentum at historic rates, demand for energy is skyrocketing, sending benchmark prices for natural gas to record levels in October. The price of coal has also quadrupled from that in 2020. China, the biggest coal importer and a major market for Russian coal has been increasing imports in light of the global shortage. Gazprom, the Russian energy giant will double the supply to 10 billion cubic meters of natural gas in 2021, double the amount in last year. An agreement was signed between Russia and India in October that pledged a supply of 40 million tonnes of coking coal to the country yearly. European countries have also been requesting additional gas supplies beyond Gazprom's contractual obligations and Russian coal. The positive performance of the energy market points towards windfall revenue for Russia, making 2021 a strong year for its economy.

Strategically, Russia has also leveraged the current energy crisis to push for the approval of the controversial Nord Stream 2 pipelines, which can significantly ease the shortfall and increase Russia's lion share of the gas market if approved.

For December, Russian gas supplies will remain low unless additional short-term pipeline capacity is booked to ship more gas into Europe. It currently stands at 107.3 mcm/d using the two key transit routes via Belarus and Ukraine as of 22nd November 2021. This coupled with the German suspension of approving Nord Stream 2 will dispel hopes of increased supplies in the short run amidst the energy crunch.

Although short-term increased capacity bookings with Russia have been rare, it is important to note that the absence of Nord Stream 2 operations will mean Europe has to implement other measures to fill up its gas storage, which has reached record lows in over a decade. The temperatures and weather of the impending winter will also be likely to affect the overall demand for gas. These factors may call for necessary interventions and unprecedented short-term bookings by the EU. As the uncertainty heightens in the gas market, analysts will have to keep a close eye on the daily auctions and capacity bookings which may indicate price hikes or drive market volatility throughout December.

However, the new Omicron variant can be a potential game-changer if it proves to be highly transmissible, resistant to current vaccinations, or more deadly. Ever since the news of the mutated variant broke out on 24th November 2021, oil prices saw the steepest monthly decline of 20% since March 2020 as business and consumer confidence wavered. Countries like Japan and Israel have entirely sealed their borders, while Canada, Australia, and the US have tightened regulations or banned arrivals from high-risk nations. As the tightening of regulations and the risk of another wave of infection looms, we might see a fall in demand if consumer and business confidence are negatively affected. This may provide some respite for the overheating economies and record-high energy markets as shortages lessen, potentially reducing high inflation in economies worldwide. However, as a nation on the supply side of the energy chain, this potential fall in demand could mean lower energy prices, which will reduce its energy revenues and current account surpluses. There will also be lesser support of the Russian Ruble, hindering further economic recovery from the pandemic. Considering that, the next few weeks will prove paramount to the markets as we closely track WHO's study of the severity of the new variant.

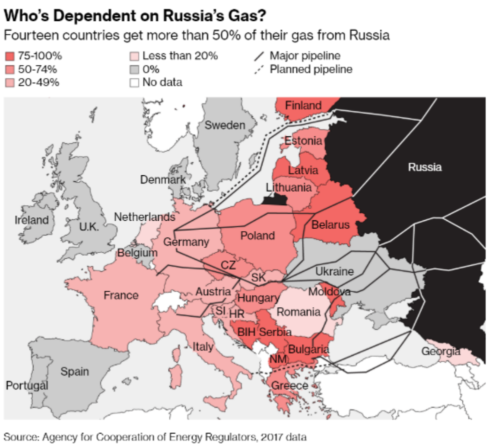
Nord Stream 2

Nord Stream 2 is a 1,230km new offshore natural gas pipeline connecting Russia to Europe across the Baltic Sea to supply gas exports. Its maximum capacity of 55 billion cubic meters of gas per year, corresponds to 12% of all the gas consumed in the EU and the UK in 2020. If operations are allowed to begin, Gazprom can directly supply up to 110 billion cubic meters of gas per year to the European market.

Figure 9: Nord Stream 2 undersea links

Source: Bloomberg

Figure 10: Russian Gas importers



Source: Agency for Cooperation of Energy Regulators

Importance:

- In the time of an acute energy crunch, the prospects of Nord Stream 2 will enable a secured supply of low-cost gas to Europe. This is vital to many European markets which are highly dependent on gas with more than half of their gas imports coming from Russia. The Nord Stream 2 will be a crucial link to secure energy supplies ahead of the looming winter and the risks of power outages due to record low gas storage. While its approval can spell the end of the crisis as households and businesses continue to grapple with soaring electricity bills and loss-making operations due to high production costs, the Nord Stream 2 pipeline continues to face hurdles from its approval.

- This pipeline also reflects Russia's gradual shift away from highly pollutive coal and nuclear energy and diversify European exports.

- With its implementation, Russia can potentially be increasing its share in the European market by 4% in 2025.

- By reducing its reliance on Ukraine as a key transit link, Gazprom will be less exposed to disruptions arising from Ukrainian tensions that have been on the rise since Soviet Union's collapse. This protects Russia from potential supply disruptions arising from future disputes and strengthens its grip on its energy supply lines.

Controversy:

- Countries along the pre-existing Nord Stream pipeline that flows through Ukraine, Poland, and Slovakia have benefitted from the collection of transit fees as gas is transported through their territories. These concerns increased after the agreement by Gazprom to continue transporting gas via Ukraine until at least 2024. These gas transit fees are important to these countries, with it making up 3% of Ukraine's GDP. As such, the unveiling of a new pipeline may potentially rob them away from these profitable streams of revenue.

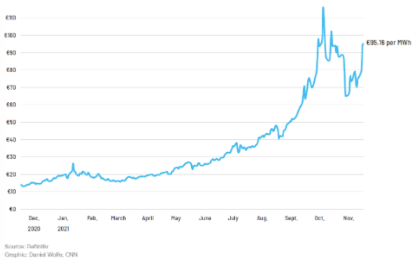
- The U.S. administration has also reinforced that the North Stream 2 will result in Europe's overdependence on Russian supplies. Meanwhile, it has also been looking to increase its own gas supply to Europe and placing significant hurdles for the approval of the pipeline.

- Global leaders have also faulted Russia as a manipulator taking advantage of its grip over oil and gas resources to push for the approval of the controversial pipeline and increase its influence in the European hemisphere. Accusations that Russia has been intentionally reducing gas supplies into the region to hike prices and push for the opening of North Stream 2 have been declined by the government.

- The dominant operator issue of North Stream 2 revolves around the conflicts in the EU Gas Directive and Russian legislation. While the EU mandates the owner of the pipeline to be different from its supplier for fair competition, Russia only allows Gazprom to export gas overseas. Hence, Gazprom would have to auction some capacity to other companies. Currently, Russia is planning to hand the export rights to Rosneft, its third-largest gas producer. Concurrently, Nord Stream 2 AG is also seeking an exemption from the EU Gas Directive.

- Germany has pledged that if Russia weaponized energy or committed any acts of aggression against Ukraine, they will sanction Russia's energy export. In the meantime, a Green Fund has been contributed by the U.S. and Germany to help Ukraine shift towards cleaner energy sources.

Figure 11: Gas prices soar following delays of Nord Stream 2 approval



Source: Refinitiv

The pipeline completed construction on 10th September 2021 but has been faced with delays by the German regulators in the certification procedures. The suspension was meted out since Germany was not able to certify Nord Stream 2 as the sole operator as it was headed in Switzerland, not Germany. This shattered hopes of the easing of the energy markets as first flows through North Stream 2 will be highly unlikely in the first half of 2022.

Following the suspension, the gas market experienced a soar in gas prices with natural gas futures in the Netherlands, the benchmark for natural gas prices in the EU reaching €95.16 per megawatt-hour (MWh). If demands continue to stay high or spike in cold winter, we may see even higher surges in gas prices. This further intensifies the European energy crunch as real concerns of rolling blackouts across the region grow in face of a cold winter. With further slowdowns in new oil production and the 60% increase in prices since the start of the year, it is plausible that the tight market may face yet another spike soon.

Ukraine-Russia Tensions

Tensions between the two countries have reached a new high as reports of the gathering of Russian troops near the borders have stoked fears of a possible invasion. This heightened alert and response comes after the controversial annexation of Crimea back in 2014, which was heavily criticized by the world. Since then, the European Union and the U.S. have imposed economic sanctions on the Russian economy. In response to the growing criticism against Russia, the Kremlin has denied all allegations of a planned invasion, justifying that they were just carrying out routine military trainings. Instead, it accused Ukraine of increasing its own military numbers to recapture the Donbas region. This has been denied by Ukraine.

Russian President Vladimir Putin has also called for agreements to prevent NATO expansion eastwards near its borders. He also specified that the deployment of missile systems and elaborate weapons in Ukraine by NATO would be "crossing a red line" and aggravating the situation in light of the re-armament of the Ukraine military by the U.S. and NATO. Moreover, Russian Foreign Minister Sergey Lavrov has also warned that any further breach will be faced with Russian intervention to protect its security interests.

On the other hand, NATO has announced that any breach or invasions by Russia will be strictly dealt with serious measures including economic and financial sanctions, and political restrictions. Likewise, the U.S., the strategic ally of Ukraine has been looking to arm Ukraine and send military backups to prepare it for a potential invasion.

Another point of contention revolves around the current Nord Stream 2 pipeline. Ukraine believes that the current land-based gas network passing through its grounds acts as an effective shield from possible Russian invasions since the gas supply will be disrupted. Hence, the opening of the new pipeline will further allow Russia to selectively target them with energy cut-offs, without affecting European supplies. This also implies that Ukraine will lack access to the lucrative transit fees that have accounted for 3% of its GDP.

Figure 12: Russia's Core Inflation Rate

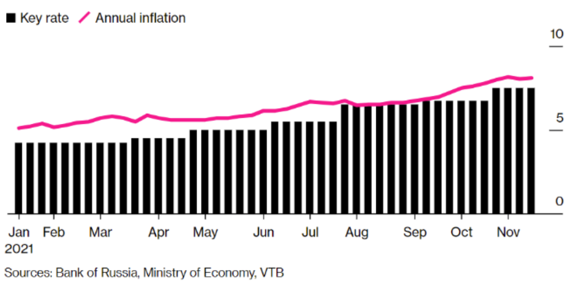
Source: Trading Economics

Central Bank of Russia

Russia has been experiencing persistent inflation throughout 2021 as the economy grapples with faster growth in demand relative to the increase in output. These supply bottlenecks have greatly inflated commodity prices, increasing the CPI index. As of October 2021, Russia's core inflation rate has reached 8% year-on-year.

To combat inflation, the Central Bank of Russia (CBR) has shifted its stance from accommodative to a neutral one by tightening its monetary policy since inflation exceeded its target rate of 4% in December 2020. As of end-October, the CBR has raised rates six times in 2021 alone, by a total increase of 325 basis points to 7.5 percent. This has enabled the economy to keep real interest rates close to zero.

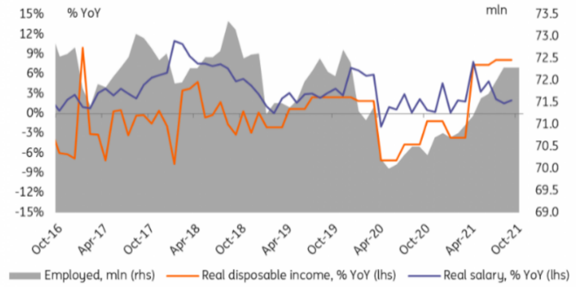
Figure 13: Inflation continues to increase despite rate hikes



Source: Bank of Russia

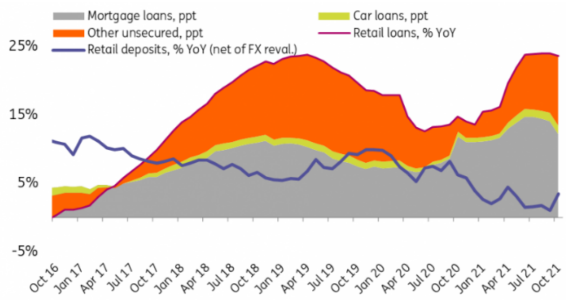
However, prices have continued to rise, fuelling Russian inflation despite the bank's continual rate hikes. This has quelled hope surrounding the stabilization of prices after the persistent inflationary pressures. As the bank maintains its hawkish stance, expectations of future rate hikes persist. This may fuel holiday demand considering the high inflationary expectations as consumers bring forward their consumption, in turn adding further inflationary pressures on the economy. In the foreseeable future, we can expect the continued

Figure 14: Tightening Labour Market



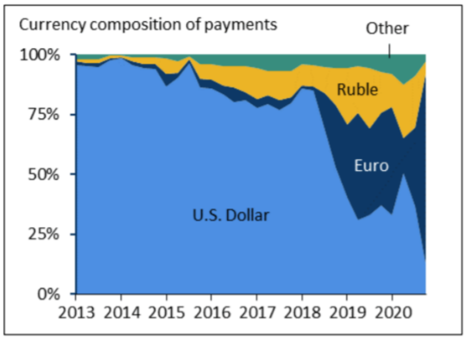
Source: Rosstat, ING

Figure 15: Deposits and Loans



Source: Bank of Russia, ING

Figure 16: Exports to BRICS Countries



Source: Bank of Russia

supply chain disruptions to weigh further on prices, making a moderation of inflation to be unlikely.

Demand-side factors are also increasingly more pronounced. Russia is facing a tightening of the labour market to pre-COVID-19 levels. This may underscore inflationary pressures on the wage channels, which will, in turn, increase firms' costs, which will be passed down to consumers and increase inflation. Despite CBR's tightening monetary policies, retail lending has not cooled, and deposit growth remains close to historic lows. These factors indicate continued inflationary pressures.

Moving into 2022, this momentum of increasing inflation is likely to stay.

De-dollarisation

With increased sanctions on the Russian Federation by the US administration over the past decade, Russia has accelerated its de-dollarization program to rid its dependence on the U.S. Dollar. These crucial steps enable the economy to be insulated from current and further future U.S. sanctions.

These initiatives have been rolled out in three areas:

The government has drastically reduced its own holdings of Dollars. This includes the CBR reducing its Dollars-dominated reserves by over half in the past 8 years. In July 2021, the Russian finance minister unveiled its aim to completely phase out the currency from its sovereign wealth fund assets, where Dollars made up a third of the $186 billion funds.

Russia has reduced its share of trade transactions in Dollars. Trade agreements with countries including China, India, Turkey, and other members of the Eurasian Economic Union to utilize national currencies in bilateral trade have been signed. Its major state-owned energy companies have also started carrying out trades in Euros and Rubles. These efforts have led to a significant change in the currency composition of the nation's trade. As of 2020, only 10% of its exports to other BRICS countries (Brazil, India, China, and South Africa) were invoiced in Dollars, a dramatic decrease from about 95% in 2013. This included the fall in Dollar-based export transactions with China, its largest trading partner, from 90% in 2013 to 60%. However, half of its total exports are still transacted in Dollars.

Mir, a new national electronic payments system was introduced to reduce its dependence on the current model centered around the U.S. Dollar. This move was made after several Russian banks had their U.S.-based payment processing companies rejected due to the sanctions. After the U.S. called for the removal of the Russian Bank from The Society for Worldwide Interbank Financial Telecommunication (SWIFT), an intermediary and executor of financial transactions for banks globally, Russia put in place a new financial messaging system—the System for Transfer of Financial Messages (SPFS). Russia has expanded the use of these systems overseas in countries like Armenia, Turkey, and Uzbekistan, and 23 banks outside the country. The CBR is also experimenting with the usage of a digital currency to further extricate itself from the American payments' infrastructure.

However, it is crucial to note that a complete de-dollarization would not be possible due to its status as a “universal currency.” The CBR governor has also affirmed that it would continue to hold onto Dollar-denominated-assets.

This shift, while yielding minimal effects today, may change the country’s economy adequately if the de-dollarization efforts persist. While it currently only mitigates the impact of American imposed sanctions on the Russian economy, this policy may shield Russia and prove favourable from an American financial crisis that may break out in light of its excessive and risky money-printing fiscal policies.

Fiscal Policy

To sustain economic growth as private and foreign investment remains low, the Russian government has pushed for an increase in state spending. In September, a draft bill proposed permanently pegging the presidential spending surcharge at 0.5% of its GDP. This will provide Russia with an additional forecasted $5.2 billion on top of the prior budget plan that fixed the surcharge at 585 million Rubles per year.

This will help the country offset negative economic repercussions from CBR’s tightening monetary policy in the face of high and unyielding inflation.

Figure 17: USDRUB Daily Chart

Source: Trading View

Figure 18: USDRUB Weekly Chart

Source: Trading View

Trade Idea: Long USDRUB

Following the recovery of the economy after a slump during the pandemic in 2020, USDRUB fell to a lower range from 74.50 to 69.50 on the back of high oil and gas prices amidst the energy crunch which supported the Ruble.

However, tables have turned since reports of a potential Ukraine invasion by the Russian military have landed the Ruble and Russian market in the red. The USDRUB saw a reversal in trend from 10th November 2021.

Biden's administration has revealed further U.S. intelligence documentation of Moscow plans for a military offensive involving up to 175,000 troops as early as 2022. This has stoked fears of an imminent war between the two nations and mounting criticism of the Russian government. NATO, the U.S., and Germany have threatened to impose severe sanctions to deter the Russian invasion. The U.S. is also considering increasing weaponry and armed forces to the Ukrainian border. With escalating tensions in the political hemisphere, we expect the Ruble to depreciate further.

Another potential catalyst for the fall in Ruble will be the newly discovered Omicron outbreak that has heightened the alert of nations around the world. With South Africa facing a new wave of COVID-19 cases and countries like Japan, Israel, and Morocco banning international entry altogether, we can expect market sentiment to decline in face of an increasingly uncertain climate. In response, businesses that have been badly battered by the unabating pandemic may choose to remain cautious and reduce output in anticipation of a possible fall in demand by consumers.

Moreover, the Organization of the Petroleum Exporting Countries (OPEC) meeting witnessed the agreement of major oil producers including Saudi Arabia and Russia to increase oil supplies in January despite the recent plunge in oil prices and new fears of a new glut in face of a spike in COVID-19 numbers in Europe and the newly emerging Omicron strain. This ascertains an increase in the availability of oil, bringing respite to the oil market and a reduction in its market volatility. As such, we can expect prices of oil to stabilise or at least increase at a slower rate. With lower oil prices predicted for the next year, we can expect export to fall. This will reduce demand for the Ruble, causing it to depreciate as well.

All these compounding factors point towards a general upward trend of the USDRUB.

Technical Analysis

USDRUB has traded between 75.50 and 73.50 in the past two weeks.

The Moving Average Convergence Divergence line reflects an upward trend. Despite the slight correction, there is still room for a further increase as reflected by the upper Bollinger band. These indicators, together with the upward sloping trend line, support our proposed long trade.

We would initiate a long at 73.60 and set out the stop loss at the bottom of the channel at 72.90 and take profit at the top at 75.30.

Entry: 73.60
Take Profit: 75.30
Stop Loss: 72.90
Risk Reward Ratio: 2.429

Analysts

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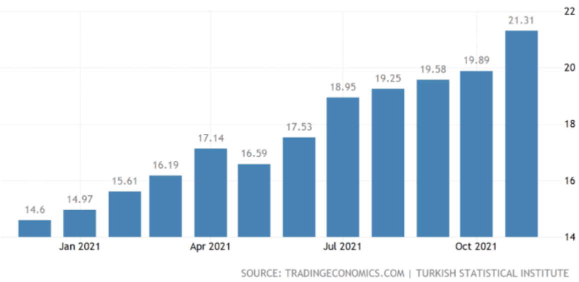
Basic Information

GDP (USD Billion)	720.101 (2020)
Interest Rate (%)	15 (Nov-21)
CPI	604.84 (Nov-21)
PPI	858.43 (Nov-21)
Con. Confidence	71.1 (Nov-21)
Bus. Confidence	108.4 (Nov-21)
Currency	Turkish Lira (TRY)

Source: Trading Economics

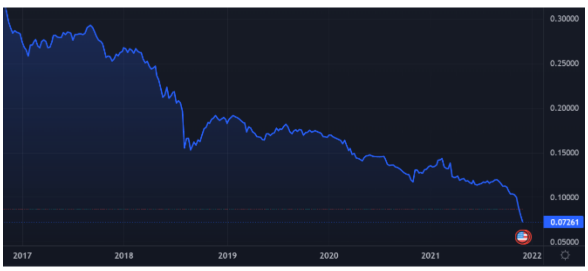
Chart info

Figure 1: Turkey's Annual Inflation Rate



Source: Trading Economics, Turkish Statistical Institute

Figure 2: Turkish Lira TRYUSD Since 2017



Source: Trading View

Overview of Turkey

- Turkey is regarded as an emerging market economy, that is dependent on foreign denominated debt to fuel growth.
- The ruling party Justice and Development Party (AKP) is known for its more authoritarian approach, with the president Recep Tayyip Erdogan favouring aggressive foreign policy and an unorthodox monetary policy, believing that lower interest rates help reduce inflation.
- Known for its high inflation in the past 4 years (Fig. 1), Turkey is experiencing a debt and currency crisis since 2018, with its Turkish Lira devaluing greatly over time (Fig. 2).
- The public debt is relatively low, at ~40% of GDP, however, half of these are foreign denominated debt.
- As its economy relies on foreign currency denominated imports to produce many of its exports and local goods, there is growing vulnerability experienced by manufacturers, farmers and retailers caused by worsening inflation and increasing global commodity prices.
- Main exports are manufactured products including vehicles, machinery and clothing, and precious metals. Main export partners are Germany (9%), the UK (6%), Iraq (5%), United States (5%), and Italy (5%).

Summary of events in the past 6 months

- Overall sentiment of Turkey's economic outlook deteriorated in the second half of 2021 amid very high inflation, central bank policy mismatches, increasing youth unemployment, worsening geopolitical tensions and global supply chain issues magnifying Turkey's economic weaknesses.
- Since increasing its interest rates from 17% to 19% earlier in the year, the Central Bank of the Republic of Turkey has performed successive interest rate cuts since September, first from 19% to 18%, then to 16% and finally to 15%. These were done despite the country's continued battle against high inflation (Fig. 1), exacerbating the issue and causing a flight from the Turkish Lira.
- President Erdogan has insisted this policy will continue, signalling further cuts in December, which caused lost confidence in the Turkish Lira, plunging its value to historic lows, breaking the once thought to be psychological barrier of 11 to the Dollar down to 13.89 to the Dollar. The Turkish Lira has lost at least 40% of its value to the Dollar this year.
- The Central Bank has attempted a few times to intervene and keep the Turkish Lira up by selling off its foreign currency reserves,

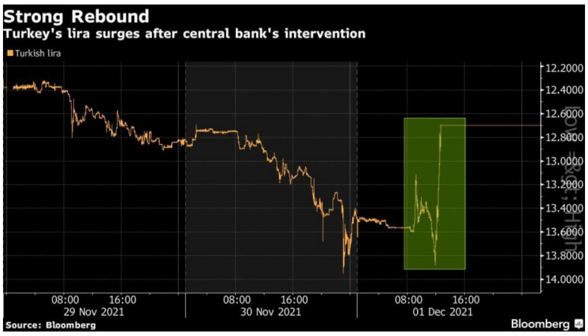
however the impact is muted as the market is aware that the reserves are being used up quickly.

- President Erdogan has replaced its Treasury and Finance Minister Lutfi Elvan with Nureddin Nebati, who favours President Erdogan's low interest rate views.

Figure 3: Turkish Lira USDTRY Devalued

Source: Trading View

Figure 4: Bank Intervention Short-Term Lira Rebound



Source: Bloomberg

Figure 5: Traders Betting On Further Weakness in Turkish Lira After Intervention

Source: Bloomberg

Currency Crisis Worsens In 2021

AKP's President Erdogan has long touted that the current economic model is incorrect, and firmly believes that interest rates are his enemy and intends to lower interest rates to fight Turkey's high inflation. In 2018, this unorthodox approach, coupled with the then large current account deficit (5.8% of GDP in 2018) and large private foreign currency debt (USD 457 billion on July 2018), caused Turkey's currency crisis turned debt crisis, where the Turkish Lira dropped 18% in value in a single day and continued to decline since.

Typically, to curb high inflation, central banks need to hike interest rates or perform indirect stealth tightening measures, to increase the cost of borrowing. Turkey's inflation sat at over 19% since August 2021 and faced increasing inflationary pressures due to global factors (Fig. 1). This was met with a monetary policy mismatch, an interest rate cut, influenced by President Erdogan, exacerbating the already high producer price index from high import costs and higher commodity prices. Annual inflation rose to 21.31% in November, higher than previous expectations.

Central Bank's Lost Independence And Weakening Influence

Since September to November 2021, the country has seen renewed negative sentiment and loss of trust in the Turkish Lira, after the central bank cut interest rates, one week repo rate, by 400 basis points from 19% to 15%. On 22nd November 2021, President Erdogan doubled down on his view that his cuts on interest rates will continue the following month till elections in 2023 and are needed to win "Turkey's economic war of independence", causing the Turkish Lira to fall by more than 12% that day, continuing its steep decline in value since November rate cuts (Fig. 3).

This signalled that the central bank has little control over their benchmark rate and are in the mercy of President Erdogan's whims, reversing its previous stance from late 2020 to early 2021 that saw interest rates, one week repo rate, increase from 10.25% to 19% by mid-2021. The loss of the central bank's independence, or perceived independence from the ruling party has eroded expectations of positive policy rate changes in the near term, with traders expecting and pricing in future rate cuts. The central bank is expected to only review the policy rate in early 2022.

To curb the freefall of the Turkish Lira, the central bank has already had to intervene twice, by selling off its foreign currency reserves, particularly USD, now totalling around USD 1 billion in sales (Fig. 4). This intervention caused a temporary rebound in the Turkish Lira value but because the market is aware of the dwindling foreign currency reserves that prevents the central bank from regularly doing this, its effect on the Turkish Lira value has largely been muted. In fact, traders have increased their bearish bets against the Turkish Lira in the options market since the bank intervention (Fig. 5).

The last time the central bank intervened in this way was in January 2014, which failed to stabilize the Turkish Lira and the Central Bank was forced to increase the benchmark rate a week after. However, this time, President Erdogan will likely not allow a rate hike.

Turkey's Gross reserves stands at USD 129 billion as of 19th November 2021, although after removing liabilities and swaps shows its net reserves stand at negative USD 35 billion.

President Erdogan has fired 3 central bank monetary policy committee members that were not accommodative of his recent rate cuts and replaced Turkey's Treasury and Finance Minister Lutfi Elvan with

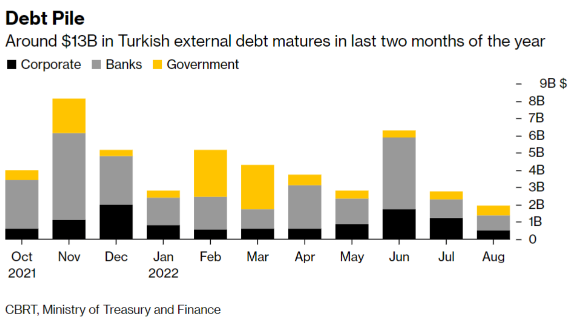
Nureddin Nebati, a replacement who favours his low interest rate stance.

Government Policies Increasing Access To Borrowing

President Erdogan has expressed interest in creating more government programs that improve access to Turkish Lira loans, one of which provides private companies 50 billion Lira in new loans from the Credit Guarantee Fund that offer interest rates that are as much as 7 percentage points lower than market rates, and another policy suggests that some zero borrowing limits that were implemented to combat Covid-19 pandemic economic woes in 2020, will continue for longer. Such policies further reduce the central bank's control on inflation.

Foreign Currency Denominated Debt Weighing On Inflationary Pressures

Figure 6:



Source: Central Bank of the Republic of Turkey, Ministry of Treasury and Finance

Turkey will have to repay some USD 13 billion of external debt maturing this year, half of which, USD 8 billion, will mature in November with most being foreign currency denominated debt (Fig. 6). This means that demand for foreign currency will increase, pressuring the Turkish Lira. As Turkey relies heavily on external financing, this tends to create a negative cycle of increasing allocation of budget to debt servicing instead of to national programs and increasing reliance on external financing. With the Turkish Lira losing its value to foreign currencies because of the inflation, the cost to service these debts and credit risk concerns will grow.

Turkish banks are also heavily reliant on foreign financing to fund lending locally. According to Fitch, lenders had successfully rolled over their syndicated loans over from abroad this year and despite Turkey's economic crises in the past, have maintained reasonable access to borrowing from abroad.

Hedging Inflation Through Dollarization

In the country's banking, more citizens are choosing to hold their deposits in foreign currencies to hedge against the devaluation of the Turkish Lira. Foreign currency deposits account for 55% of all deposits in the country, an increase from 49% in 2018. The expectation of inflation has cemented less demand for Turkish Lira among the populace, pressuring the lira further. There is increasing risk of the complete loss of trust in the Turkish Lira, which could cause a bank run, not seen since 2001.

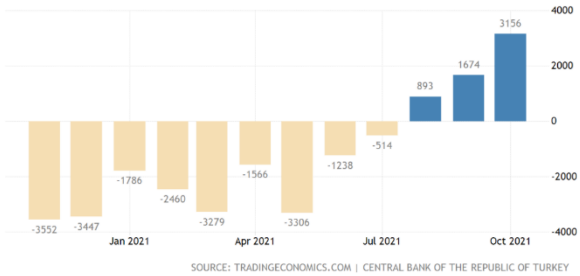
Contrary to the government's firm belief that the inflation will pass as supply side inflationary pressures ease in the medium term, we believe that this monetary policy mismatch will exacerbate the still large foreign currency denominated debt problem in Turkey and may freeze Turkey's GDP growth and recovery it has experienced recently. Overall, the Turkish Lira will prove more and more unreliable as a currency and become more and more undesirable by both its citizens and corporations, and foreign entities, increasing Turkey's reliance on foreign currency denominated debt, a negative feedback cycle.

Economy – The Numbers And The People

Current Account Surplus And Narrowing Trade Deficit

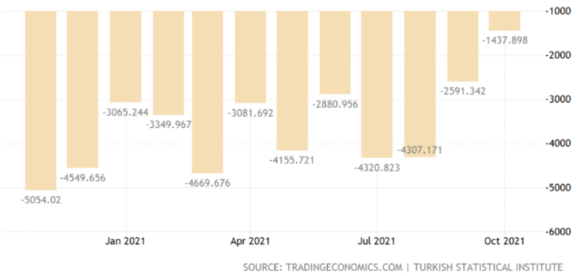
Turkey's current account has been in surplus for 3 months in a row, after being in deficit for 8 months (Fig. 7). In October 2021, Turkey achieved a surplus of USD 3.16 billion. This beat market expectations of USD 2.4 billion and is higher compared to the USD 0.9 billion deficit

Figure 7: Turkey's Current Account



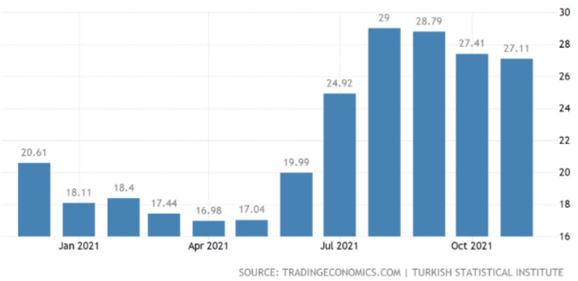
Source: Trading Economics, Central Bank of the Republic of Turkey

Figure 8: Turkey's Balance of Trade



Source: Trading Economics, Turkish Statistical Institute

Figure 9: Turkey's Food Inflation



Source: Trading Economics, Turkish Statistical Institute

the same month in the previous year. According to the central bank, this development is due to the net outflow of goods decreasing by USD 2.6 billion compared to the previous year and net inflow of services increasing by USD 2.28 billion.

The trade deficit narrowed sharply to USD 1.44 billion in October 2021, from USD 2.4 billion in the same period last year (Fig. 8). This is riding on the back of increased global demand of its exports which increased some 20.1% to a high of USD 20.79 billion.

We expect that due to the recovery of the tourism and transportation sectors from the pandemic, that the foreign trade deficit will further narrow, and the current account deficit will lessen accordingly.

Currency Crisis Causing Instability On Import Prices

As an emerging market, Turkey is greatly affected by the global supply shortages as it imports most of its raw materials to produce its exports and local goods, with imports to GDP reaching 32% in 2020, whereas exports to GDP being only 28% in the same year. Because of this heavy reliance on imports, Turkey's economy will be more negatively affected by the rising oil prices, increasing global commodity prices and the decline in Turkish Lira. As the Turkish Lira weakens, imports will cost much more for manufacturers and this exchange rate differential will eat into their margins.

Because of the severe weakening of the Turkish Lira in the last quarter of 2021, there is risk that companies might find it less costly to hold onto their goods instead of selling them, which could lead to a big economic slowdown going forward. Local consumers are more likely to keep their deposits in foreign currency deposits and will be more uncertain about the Turkish Lira. With food prices increasing greatly every month, they will attempt to hedge by using their Turkish Lira quickly, buying precious metals or converting to other currencies, causing more pressure on the Turkish Lira (Fig. 9).

This vulnerability is very apparent in the energy sector, where there is almost total dependency on imports to meet energy needs of the country, needing to import some 75% of its energy needs. Over the last 15 years, Turkey has had the highest rate of growing energy demand amongst countries in the OECD, with energy imports totalling USD 41 billion in 2019. Turkey's imports of Liquified Natural Gas have also increased in 2020, now representing 29% share of the market. Turkey is aware of this dependency and has energy exploration initiatives in the Eastern Mediterranean and Black Sea, although it may take many years to reduce this dependency.

Although the current account has reported a net surplus since August 2021 after more than 7 months of reporting a deficit, there is uncertainty on whether this trend will continue, given the currency crisis and global trends.

GDP

Turkey's economy grew 7.4% for quarter 3 of 2021, year-on-year, with GDP growing 2.7% compared to the previous quarter, seasonally adjusted. We believe that this is due to the Covid-19 pandemic global recovery fuelling retail demand, and exports, which helps Turkey's manufacturing and agricultural sector. It is important to note that there is growing risks of an economic crisis from decreased growth caused by the currency crisis.

Quality Of Life And Decent Work

Decent work and quality of life in Turkey is poor. Unemployment rates are concerning and, on the rise, while the country's volatile sociopolitical climate worsen the existing economic instability. This is exacerbated by the 3.6 million Syrian refugees entering Turkey which has created new challenges. Turkey's traditional culture and values are key barriers to achieving decent work. Cumulated with the country's relative poverty, decent work becomes unlikely for the vulnerable. While programmes like the ISDEP and joint programmes with UN organisations have been executed, there remains a much bigger gap for Turkey to fill.

Traditional gender roles remain prevalent in the workforce. The labour force participation rate of females is still less than a third of the total labour force. Roles as wives and mothers for women are still the consensus. Other than perpetuating that women are limited to unpaid, domestic work, these underlying beliefs also endorses discrimination right from the hiring stage.

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

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

Development In Geopolitical Relations

European Union

President Erdogan's Turkey continues to put strain on the country's relations with the European Union with his fierce foreign policy approach.

Turkey's accession negotiations have once again come to a standstill. The EU summit in March reaffirms that the EU still has economic interest to maintain and improve its relations with Turkey. However, the EU is firm on its stance that it disagrees with AKP's "erosion of democracy and rule of law". In its annual report this year, the EU argues that Turkey's autocracy and continued violations of membership criteria have been detrimental to the progress of its membership. Furthermore, the union also highlighted that their recommendations to the country have been disregarded. Restrictions on Ankara's attempts to reform various areas of the state have also been provisional, with civil and political freedoms remaining limited. In line with these issues, possibility of the annulment of the country's membership bid has surfaced. This has put back Turkey's aim of being a full-fledged EU member and should an annulment be pursued, would be detrimental to Turkey's economic interests.

United Arab Emirates

Meanwhile, the United Arab Emirates have recently made efforts to rectify past disputes with Turkey regarding the Eastern Mediterranean and Gulf. Memorandums of Understanding were signed between Abu Dhabi Development Holding, Turkish Wealth Fund and the Turkish Presidency Investment Office, which aims to improve financial cooperation between the nations. This economic partnership will increase investments in Turkish technology firms, improve ports and logistics cooperation and establish cooperation on energy and infrastructure development. This development includes establishing a USD 10 billion fund mainly for investments into health and energy fields in Turkey.

Furthermore, Turkish and Emirati central banks have signed agreements, including potentially holding talks on a swap agreement, which could help Turkey source hard currency and swaps to support the decline in Lira and increase its foreign currency reserves. This development comes after a shift in foreign policy tone towards its rivals, namely the UAE, Egypt, and Saudi Arabia, although only the relations with UAE has yielded an improvement so far.

United States

Relations between the United States and Turkey are at an all-time low, with no new positive developments between the nations. Recently, President Erdogan had threatened to expel a U.S. ambassador to Ankara and 9 other Western envoys, after they called for the release of Turkish philanthropist Osman Kavala. In the end, they weren't expelled but the incident showed how easily ties can deteriorate, with a divorce between the two nations disastrous for Turkey as it is reliant on US and Western countries for its national defence, which would cause foreign investors to dispose of Turkish Lira denominated assets en masse.

Trade Idea: SHORT TRYUSD

Figure 10: TradingView TRYUSD Hourly Chart

Source: Trading View

Figure 11: TradingView TRYUSD Daily Chart

Source: Trading View

Figure 12: TradingView TRYUSD Weekly Chart

Source: Trading View

Narrative

Although Turkey's economy has been improving in 2021, benefitting greatly from the global recovery from the pandemic and renewed demand for their exports, the Turkish Lira has fallen at least 40% to the dollar this year alone following the currency crisis in late 2021. As President Erdogan has doubled down on his claim that the interest rate policy will remain unchanged and remarked that the Central Bank may try intervening directly in the exchange rate market, there is little reason to believe that the Turkish Lira will not continue to fall against the Dollar.

Firstly, the Central Bank's ability to intervene effectively is low as their foreign currency reserves have been low since 2020, having unable to replenish them effectively since. The recent intervention proved to be mostly ineffective.

Further to add, with Fed guidance implying that they are tapering sooner than expected and that inflation is not in fact "transitory" as previously suggested, the USD should continue to strengthen. This is also because Turkey is undergoing bouts of high inflation that its policymakers are unable to combat, and a strengthening USD will be more appealing to investors, hence justifying the case for sustained flight away from the Turkish Lira, causing the Lira to lose more of its value against the Dollar. Recent developments with the UAE will likely not improve the currency situation, nor negate its effects on the growth of the economy in the short to medium term.

Technical Analysis

The recent drop in November has already retraced at least 61.8 percent, hence we believe that the decline will continue coming around the December's expected rate cut. The recent resistance level is at 0.0763.

Trade

This trade idea is riding on the decline in Turkish Lira that is expected to continue after December's rate cut is officially announced. The trend will likely continue unless December's expected rate cut does not happen. If the predominant narrative that President Erdogan has vowed will continue does not actually continue, and emergency rate hikes occur, this trade may fail, hence we set our stop loss at the recent resistance level which will limit our losses early on should the price go up. Take profit is at a new low, 0.0674.

Entry: 0.07273
Take Profit: 0.0674
Stop Loss: 0.07632
Risk Reward Ratio: 1.47

NUS INVESTMENT SOCIETY

Global Macro Department – South Africa (UNDERWEIGHT)

Date: 15th December 2021

Analysts

Zahid Afiq
Global Macro Analyst
e0857438@u.nus.edu

Basic Information

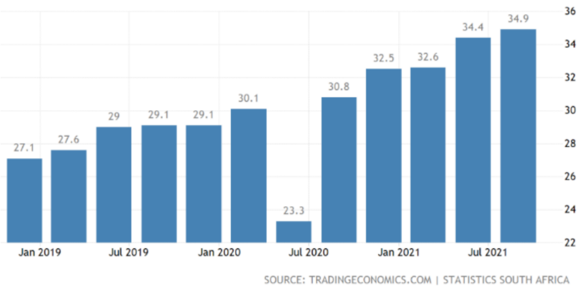
GDP (USD Billion)	301.924 (2020)
Interest Rate (%)	3.75 (Nov-21)
CPI	122.9 (Oct-21)
PPI	107.9 (Oct-21)
Con. Confidence	-10 (Nov-21)
Bus. Confidence	43 (Nov-21)
Currency	Rand (ZAR)

Chart info

Figure 1: South Africa's Annual Inflation Rate

Source: Trading Economics, Statistics South Africa

Figure 2: South Africa's Unemployment Rate



Source: Trading Economics, Statistics South Africa

Overview of South Africa

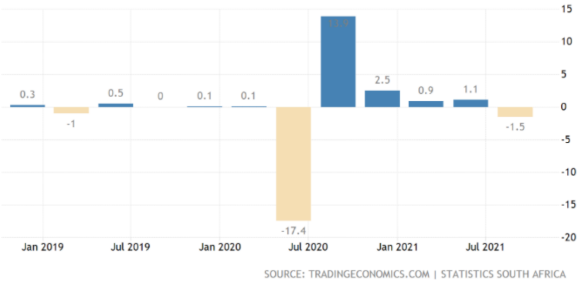
- South Africa is an emerging market economy, being the third largest GDP in 2020 in Africa, after Nigeria and Egypt.
- South Africa is one of the most industrialized and technologically diverse economy in Africa.
- Known for its high unemployment of 34.9% and even higher youth unemployment 46.3%, its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

Summary of events in the past 6 months

- Overall sentiment of South Africa's economic outlook deteriorated in the second half of 2021 amid reports of the new Omicron variant of Covid-19, which appears to be able to spread much faster than the Delta variant. The pandemic and energy supply constraints are expected to effect investor confidence and job creation, especially in the recovering labour-intensive sectors.
- On November 18, 2021, the South African Reserve Bank increased its repo rate from 3.5% to 3.75%, an increase of 25 basis points. The prime lending rate of commercial banks are now up to 7.25%. The inflation rate currently sits at 5% for October 2021 (Fig. 1). The annual inflation rate is expected to be 4.5% in 2021, and 4.3% in 2022, within its inflation target range of 3%-6%.
- The unemployment crisis worsens with unemployment rising to 34.9% in Q3 2021 (Fig. 2). Youth unemployment is at 46.3%.
- The new Omicron variant of Covid-19 appearing in South Africa has caused a scare in international markets, with many countries either restricting travel to and from South Africa or advising against doing so. The Omicron variant is more transmissible than the Delta variant and since its emergence, South Africa's daily Covid-19 cases have increased again.
- South Africa's GDP growth has declined by 1.5% on quarter in the three months to September 2021 (Fig. 3). The agriculture sector, manufacturing sector and trade sector reported the biggest decline out of the six industries that declined, declining 13.6%, 4.2% and 5.5% respectively.
- South Africa experienced a civil unrest in July following the imprisonment of its former President Jacob Zuma for contempt of

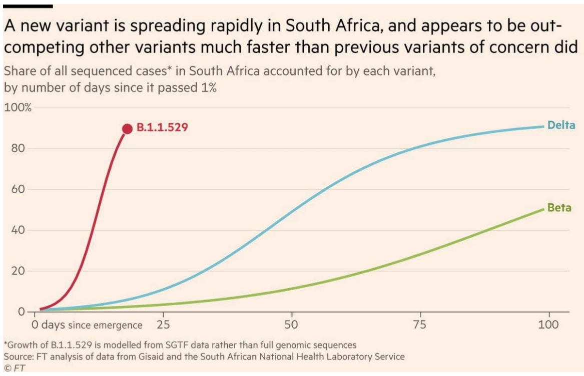
court. Large riots and lootings resulted from weeks-long protests against news of the imprisonment.

Figure 3: South Africa's GDP Growth



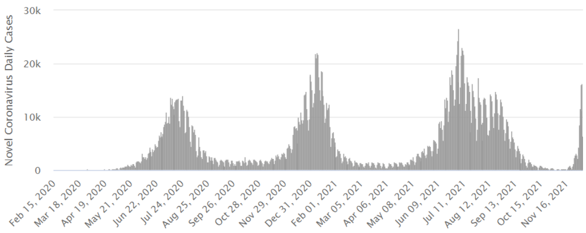
Source: Trading Economics, Statistics South Africa

Figure 4: Omicron Variant Transmissibility



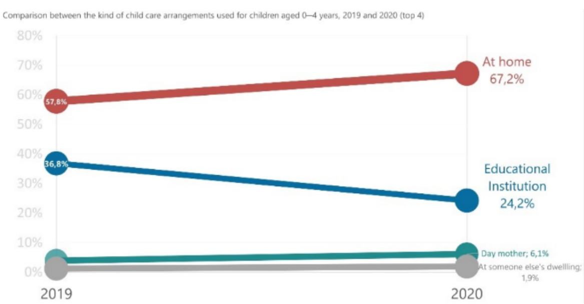
Source: Financial Times, Gisaid, South African National Health Laboratory Service

Figure 5: South Africa's Covid-19 Daily Cases



Source: Worldometers

Figure 6: South Africa's Children Age 0-4 Educational Institution Attendance



Source: Statistics South Africa

South Africa's Covid-19 Woes Resurfaced

Omicron Variant

The Omicron variant first appeared in South Africa and is considered South Africa's fourth wave of Covid-19, according to CDC Africa. The Omicron variant statistically spreads significantly faster than the Delta and Beta variants (Fig. 4). In October, South Africa appeared to have contained the pandemic and had daily cases nearing 300 cases, the lowest figures recorded this year, but since the Omicron variant appeared, the daily cases have hit 16,000 on December 3rd (Fig. 5). It is apparent that the new variant is dominant in South Africa, with over 70% of all viruses sequenced to be of the Omicron variant.

According to South Africa's National Institute for Communicable Diseases, people who have already had other variants of Covid-19 do not appear to be protected from this variant but expects the vaccines to still protect against severe disease. South African representatives hopes there will be calm as early data shows that the new variant may not be more dangerous than other variants, but more data is needed to properly understand the implications of this variant.

This news triggered other countries to impose travel restrictions particularly towards South Africa and have caused uncertainty in the international markets. Since the emergence of this variant in October, Crude oil futures have been going down, with nations tapping on their oil reserves and OPEC+ continuing their output hikes.

The Omicron variant has appeared in at least 24 other countries, and it is expected to reduce investor confidence in South Africa and cause further lockdowns that will impact the growth of the nation. There is increased uncertainty because of the lack of clarity in vaccine effectiveness against this variant and how much the travel restrictions will threaten domestic industries.

A Nation Still Recovering From The Previous Waves

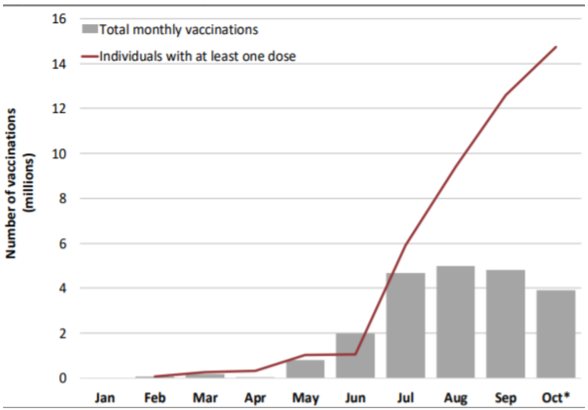
The Covid-19 pandemic has hit emerging markets harder, with South Africa imposing Covid-19 regulations that forced schools and educational facilities to shut down. The percentage of children attending childhood education has decreased from 36.8% to 24.2% in 2020, while percentage of children that remained at home increased from 57.8% to 67.2% during the same period (Fig. 6).

According to Statistics South Africa, Covid-19 Social Relief of Distress grants among other grants, represented the second most important source of income (52.9%) for households after salaries (57.6%), in 2020. With such a large percentage of households depending on these fiscal relief grants, we are concerned on how long the government can fund these programs. The Second Special Appropriation Bill 2021 increased the funding for fiscal relief packages, providing the temporary Social Relief of Distress grants till the end of 2022 with broadened eligibility to caregivers, support for small businesses affected by Covid-19 restrictions and the July violence by R1.3 billion and another R5.3 billion to the Unemployment Insurance Fund.

Covid-19 vaccination rates are low, at 24% in South Africa, compared to the European average of 54%, and vaccination programs have mostly picked up pace after higher daily case numbers were reported (Fig. 7). There's reportedly no vaccine shortage but sentiment around vaccines is still low in South Africa which needs to change for South

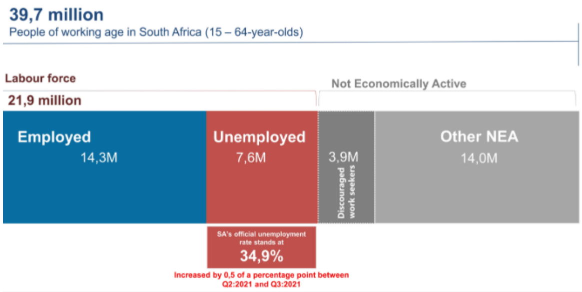
Africa to reach at least 60% vaccination rate to achieve some level of herd immunity.

Figure 7: South Africa's Vaccination Progress



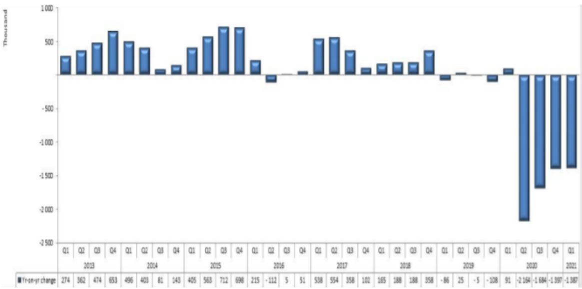
Source: Statistics South Africa

Figure 8: Unemployment in South Africa



Source: Statistics South Africa

Figure 9: South Africa's Total Employment Year-On-Year



Source: Statistics South Africa

Unemployment And Job Crisis

Unemployment

According to the Quarterly Labour Force Survey, for quarter 3 2021, South Africa's unemployment rate increased by 0.5% to 34.9%, the highest recorded since the survey began in 2008 (Fig. 8). Discouraged work seekers and not economically active for reasons other than discouragement increased by 988,000. The trade industry shed 309,000 jobs, community, and social services 210,000 jobs and construction and private households shedding 65,000 jobs each. This suggests that the economy is still undergoing high job losses and economic inactivity (Fig. 9). This trend has continued for many years, only exacerbated by the pandemic lockdown restrictions.

Among young people between the ages 15-34 years, the unemployment rate was 46.3%, which means almost half of young people in the labour force did not have a job. As the burden of employment is concentrated among youths, as they represented 59.5% of the total number of unemployed persons, this unemployment trend is worrying.

Youths appear to face extreme difficulties with the labour market, where previous work experience and a higher level of education are more sought after. As youths typically do not have prior work experience, and the skill levels tend to be low, there is a mismatch of what the market needs and what youths are equipped with. In cases where youth do attain jobs, they have contracts that do not specify the duration and do not have access to employee benefits such as medical aid, pension funds, paid sick leave or permanent employment, leaving them with vulnerable employment.

Education System

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

Restrictive Labour Laws

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

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

July Civil Unrest

Former South African president Jacob Zuma was charged with corruption, with regards to the South African Arms Deal worth R30 billion. On 29th June 2021, he was sentenced to prison for 15 months for contempt of court for not appearing at a commission regarding the corruption. The Civil unrest began on 9th July 2021, after the high court upheld his prison sentence.

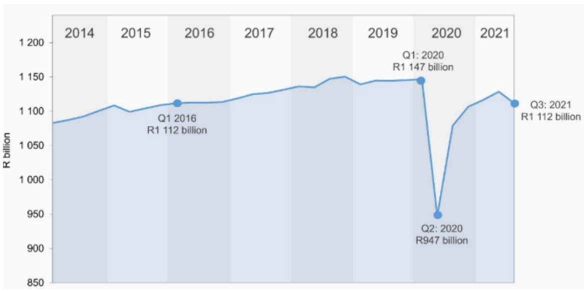
Damage

The civil unrest resulted in burglary and damage to properties in parts of KwaZulu-Natal, with riots and violence escalating on 12th July 2021, forcing malls to close and companies to stop operating. It was reported that some 200 shopping centres suffered damage, 100 malls experienced arson attacks, 1,400 ATMs and 300 banks and post offices were vandalized.

The civil unrest caused investor uncertainty, and SMEs were reported to be significantly affected, resulting from property damage and loss of business. The acting minister said estimates of the cost of the unrest to be around R50 billion to the national economy.

The protests caused 300 lives to be lost and has spread a narrative that the violence was not just from President Zuma's imprisonment but also from a growing negative sentiment by unemployed and poor South Africans of the nation's corruption and high unemployment that have not improved in the last few years. This violence and unrest highlight South Africa's vulnerability to social instability. As fiscal relief is already spread thin on other social concerns, provisions for damages from future social instability will inhibit the government's fiscal space.

Figure 10: South Africa's Economy in Q3 2021



Source: Statistics South Africa

Economy Under Uncertainty

Inflation

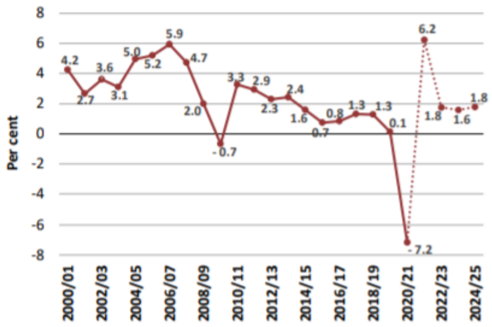
South Africa's annual inflation rate at 5% is regarded as a big concern to the South African Reserve Bank, and in response have hiked interest rates by 25 basis points from the all-time low of 3.5% to 3.75%. Prime lending rate of commercial banks are now up to 7.25%. The inflation rate is still relatively within the target range of 3%-6%, but the central bank aims to keep the rate near the midpoint of this range for the next two years. This rate hike comes earlier than many economists expected as the economy is still recovering from the pandemic and recent civil unrest and shows the central bank's concern regarding upside inflation risks.

Although this represents positive news for the currency, there is uncertainty on whether the rate hike is too soon. We expect that GDP growth will slow down with the increased unemployment and lockdowns that will be introduced because of the new Covid-19 wave brought on by the Omicron variant, hence we believe that the rate hike may further reduce South Africa's GDP recovery in the medium term.

GDP Growth And Economic Activity

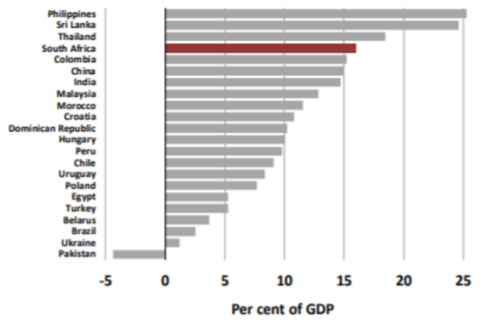
South Africa's GDP growth has declined by 1.5% on quarter in the three months to September 2021 (Fig. 3). The agriculture sector,

Figure 11: South Africa's GDP Growth and Projections



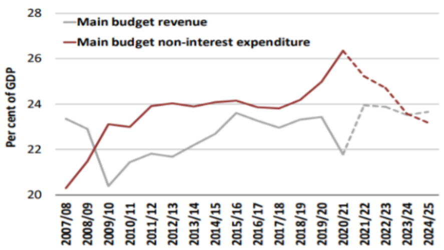
Source: Statistics South Africa

Figure 12: South Africa's Projected Three-Year Change to Debt to GDP



Source: Statistics South Africa

Figure 13: South Africa's Budget Revenue



Source: Statistics South Africa

manufacturing sector and trade sector reported the biggest decline out of the six industries that declined, declining 13.6%, 4.2% and 5.5% respectively. Quarter 3 of 2021's level of GDP is on par with the quarter 1 of 2016 (Fig. 10).

Agriculture declined the most since 2016, mainly caused by fire set off during the social unrest and decline in production of animal products. All trade sectors reported losses after wholesale, retail and motor trade were severely negatively affected by the looting and large losses from destruction of property and loss of business.

According to South Africa's 2021 Medium Term Budget Policy statement, the annual GDP growth is expected to recover to 5.1% before normalising to 1.7% the following year. The long-term GDP growth decline (Fig. 11), is mainly due to structural weaknesses such as poor education system causing higher youth unemployment and events like the July social unrest, Eskom near collapse and energy crisis. In fact, it is noted that because of the high number of external shocks that have happened recently, the fiscal space of the government has been severely limited should a new event occur, like the new wave of Covid-19 cases from the Omicron variant.

Thus, we can expect that the fiscal strength of the government will weaken to handle the surge and the prospects of more lockdowns and travel restrictions imposed by other countries will slow down the GDP growth more than the expectations from the budget policy.

Debt Servicing Costs And Financing

Public finances are weighing down on South Africa, reducing its ability to generate more growth.

Gross debt is forecasted to grow from 69.9% of GDP in 2021-2022 to 77.8% of GDP in 2024-2025 (Fig. 12). The increasing debt servicing costs will take a greater portion of the national income, which will reduce the spending on other important social programs that are supposed to improve infrastructure and curb poverty. Debt service costs is expected to be expensed up to 21% of all rand collected in the budget revenue over the medium-term expenditure framework.

Government expenditure has exceeded its revenue for more than a decade, with much of the recent increase attributed to an increasing public-service wage bill that takes up 35% of expenditure. Increased debt redemptions, some R423.4 billion of debt borrowed in previous years matures, reducing the fiscal health of the government further. As the interest rate the government pays on its debts is higher than the GDP growth, there is not much room to reduce the debt to GDP ratio without first running a primary budget surplus.

We believe that there is a need to increase economic growth before the government can increase its spending to maintain macroeconomic stability, and currently the government is set to be restrained in its spending.

Figure 14: TradingView ZARSGD Hourly Chart

Source: Trading View

Figure 15: TradingView ZARSGD Daily Chart

Source: Trading View

Figure 16: TradingView ZARSGD Weekly Chart

Source: Trading View

Trade Idea: SHORT ZARSGD

Narrative

There is much uncertainty regarding the Omicron variant to date, but the effects of the current and future travel restrictions imposed on South Africa and government-imposed lockdowns, compounded by the added fiscal pressure from the government to finance the economic drawdown from heightened Covid-19 measures, will likely dampen investor sentiment in the medium term and reduce foreign demand for the South African Rand.

It is apparent that investor sentiment is near its lowest levels in recent times as the latest rate hike did not go down well with investors, as the Rand declined further against most developed economies' currencies after the announcement.

Owing to the aforementioned uncertainty, especially with regards to the efficacy of vaccines against the Omicron variant, the resurgence of Covid-19, record high unemployment and social unrest, as well as the already weak fiscal health of the government, any bad news will likely cause the Rand to dip further – while prospects of good news are few. This means that risks to the Rand's strength are understandably skewed to the downside, including further bad news on the Omicron variant front or successive misses of GDP growth estimates, which should erode investor sentiment and demand for South African Rand.

Rosy outlook for the Singapore Dollar

Unlike South Africa, with its low vaccination rate, multiple travel restrictions imposed, and increased lockdowns caused by the emergence of the Omicron variant, Singapore has a decent vaccination rate of over 80 percent of its citizens vaccinated, and have been less affected by travel restrictions from the Omicron variant. Both countries experienced a surge of new cases in recent months, although the reasons differ. For Singapore, the surge in cases is attributed to its gradual reopening measures, whereas in South Africa, it is mainly from the Omicron variant.

Both countries have been benefitting from increased global trade, with Singapore seeing increased demand for its exports and a positive GDP growth of 7.1% in 3Q 2021 on a quarter-on-quarter basis. On the other hand, South Africa has experienced shocks and setbacks like its July unrest and sudden new wave of Covid-19 cases that have caused a decline in expectations for GDP growth in the latest quarter.

The SGD strengthened against the Dollar after MAS tightened its monetary policy unexpectedly in October 2021, the first tightening move in 3 years – demonstrating the Singapore central bank's (MAS) commitment against inflation. We believe that the SGD will likely continue to strengthen on the back of the global Covid-19 recovery much more than the South African Rand will, even amidst the Omicron variant uncertainty. Negative developments on the Omicron variant front will likely negatively affect the South African Rand to a larger extent than the SGD.

Technical Analysis

The resistance lies around 0.086, while support lies around 0.0845 and 0.084 mark. There appears to be a few retests of the resistance on the daily and hourly charts and appears to be a strong resistance line.

Trade

The trade idea is to short the ZARSGD pair. We expect the resistance line to remain strong even if it were to retest, hence our stop loss will be just above the resistance line. Any negative catalyst or simply a retest to the lower support level will reward this trade. As the stop loss is very near the resistance line, volatility or any perceived good news regarding the Omicron variant or lifted travel restrictions may cause this trade to fail. As there is much uncertainty in South Africa, volatility poses the greatest downside risk to our trade.

Entry: 0.0858
Take Profit: 0.0837
Stop Loss: 0.0867
Risk Reward Ratio: 2.33

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