MyStratWeekly

Market views and strategy

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N° 097 // **January 23, 2023**

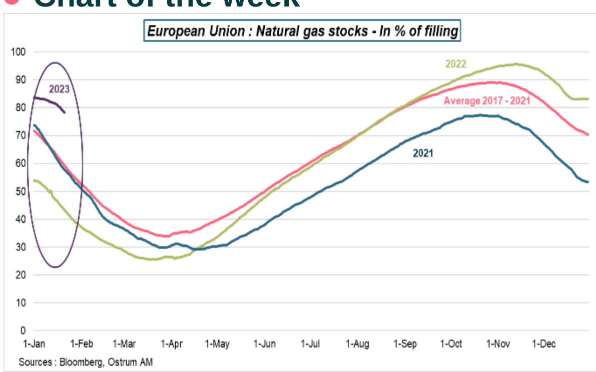
Topic of the week: Weak dollar and China: the explosive cocktail for commodities

- **The planets are aligned for 2023 to be the year of commodities;**
- **China and Russia play a decisive role in the balance of the oil market;**
- **Industrial metals to be the big winners;**
- **We continue to favor Latin America, particularly Peru and Chile. The rise in prices should improve their terms of trade and support their currency.**

Market review: Markets take a breather

- **US growth weaker towards the end of last year;**
- **ECB keeps hawkish stance despite rumors of smaller hike in March;**
- **BoJ procrastination sparks bout of volatility;**
- **Profit taking on equities after strong start of year.**

Chart of the week



European Union natural gas stocks are historically high at this time of year. They are 78% full of capacity, compared to 42% in 2022 and 58% on average over the 2017-2021 period. This results from the measures taken by the various countries to replenish them before winter via a sharp increase in supplies outside Russia, particularly in LNG, but also from the drop in demand linked to unusually mild temperatures and efforts to reduce energy consumption. Stocks are so high at this time of year that in France, GRTgaz has indicated that it has to reduce them to comply with technical constraints.

Figure of the week

96

Source : Ostrum AM

The US 1-year CDS rose sharply to 96 on January 23, the highest since July 2011. This follows the alert given by Janet Yellen. The debt ceiling was reached on January 19 and the Treasury is taking steps to avoid a default. She called on Congress to raise or suspend that cap.

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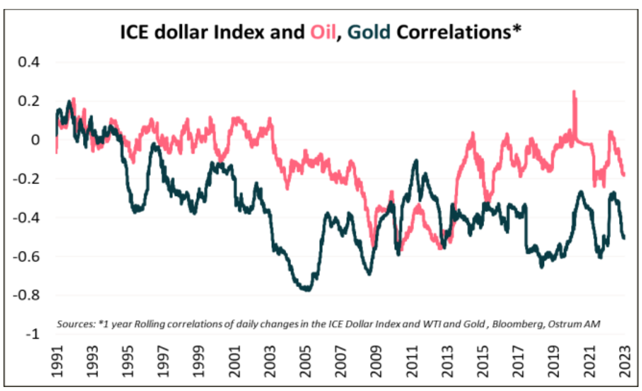
Topic of the week

Weak dollar and China: the explosive cocktail for commodities

The year 2023 begins against a backdrop of a weakening greenback and a rebound in industrial metals, following the reopening of China. Will 2023 be the year of commodities?

A weak dollar should support prices…

The dollar is the currency of many commodities, its evolution therefore influences prices. The correlation between the dollar and the commodities is on average negative, as shown in the graph below which represents the correlation between the ICE dollar index and the oil prices, as well as those of gold.

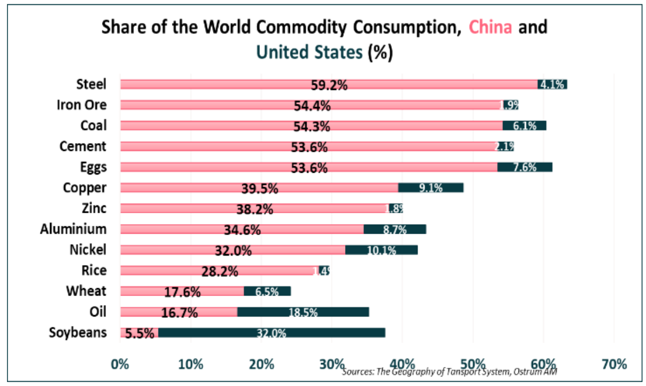


When the dollar strengthens, commodities become more expensive in currencies other than the dollar. This effect tends to have a negative impact on global demand which then drives down prices.

The greenback is also a "risk-off" currency, i.e. it benefits from the status of "safe haven" when risk aversion is high in the financial markets. Fears of a global recession dissipated at the start of the year, due to the fall in energy prices, particularly for the euro zone. The consequence has been a weakening of the dollar, like the ICE dollar index which has recorded a decline of almost 10% since the beginning of November 2022. The improvement in investor sentiment should lead to a weakening of the greenback.

… But China is the "game changer"!

China is a key player in commodity markets, as shown in the chart below.



Its share in the world consumption of many commodities exceeds that of the United States, in particular for industrial metals and agricultural products. It is therefore the main important determinant for commodities prices.

After three long years of absence, China is finally opening up in force! Covid-19 contaminations have quickly peaked in major cities, as well as in many provinces, metro traffic is normalizing to almost ¾ of normal, compared to ¼ at the end of 2022. Air traffic is also picking up. The number of flights departing from Beijing and Shanghai is expected to increase rapidly in the first months of 2023 and should remain high after having more than doubled compared to April 2022, as shown in the following graph.

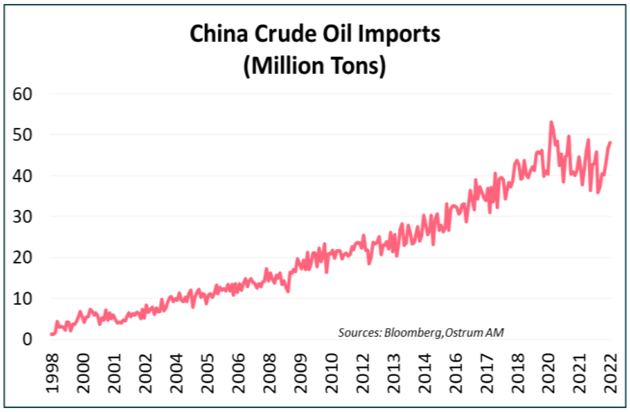
The opening of China, as well as the end of travel restrictions in other Asian countries, should result in a rebound in air traffic and therefore an increase in demand for kerosene.

Who will be the big winner?

Oil: China and Russia as main players

The crude market, governed until now by supply, should now be regulated by demand, particularly that of China.

Reflecting the end of the "Zero-Covid" policy in China, Chinese imports of crude oil rebounded in December, reaching 48 million tons, an increase of 20% compared to the previous three months of the year, figure well above the 2017-2021 average of 41.5 million tons (graph below).



China also increased, for the second time, in January, its crude oil import quotas for 2023 by 20% compared to the same period in 2022. This allocation was made earlier than usual to stimulate its economy weakened by the "Zero-Covid" ideology and encourage the production of private refiners. The risk is therefore bullish on Chinese demand for crude. According to the International Energy Agency (IEA), world oil demand could increase by 1.9 million b/d to reach a new record in 2023 at 101.7 million b/d (compared to 99.9 million b/d for 2022), linked to the opening of China which would be responsible for more than half of the increase. The "Zero-Covid" ideology depressed economic activity last year, causing Chinese oil demand to fall by 390,000 bpd, its largest annual drop, for the first time since 1990!

Global demand for crude should therefore remain robust in a context where supply is expected to slow down due to Western sanctions against Russia.

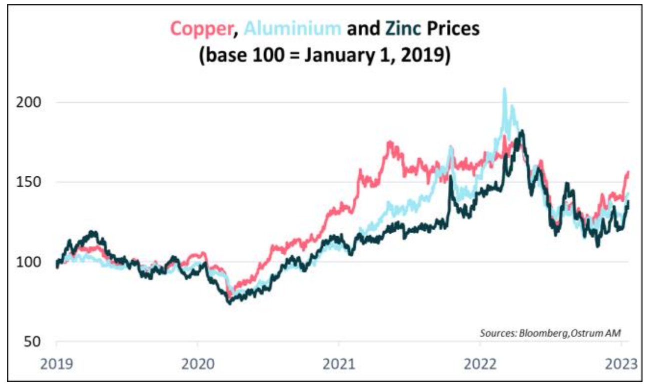
On December 5, the European Union and the G7 agreed to impose a price cap for Russian oil at $60, restricting access to insurance and delivery services for buyers who do not respect this threshold. The European Union has also halted most imports of Russian crude by sea from the beginning of December 2022 and aims to end purchases of petroleum products by sea from February 5, putting further pressure on country's energy revenues.

This cap led to a price discount for the Urals, the benchmark oil index for Russia, which traded at roughly half the price of Brent. These sanctions should impact Russian oil production by 500,000 to 700,000 b/d, according to Russian authorities. Instead, the IEA forecasts a drop of 1.6 million b/d, i.e. an average production of 9.7 million b/d. Average Russian crude production was 10.74 million b/d in 2022.

In conclusion, the balance of the oil market could deteriorate rapidly, as Western sanctions against Russia really take effect. This is a support factor for crude oil prices.

Industrial metals should be the big winners

The year 2022 was marked by a fall in the prices of industrial metals, in particular copper (-13.6%), zinc (-16%) and aluminum (-15.3%), i.e. the so-called "green" metals, involved in the composition of renewable technologies.

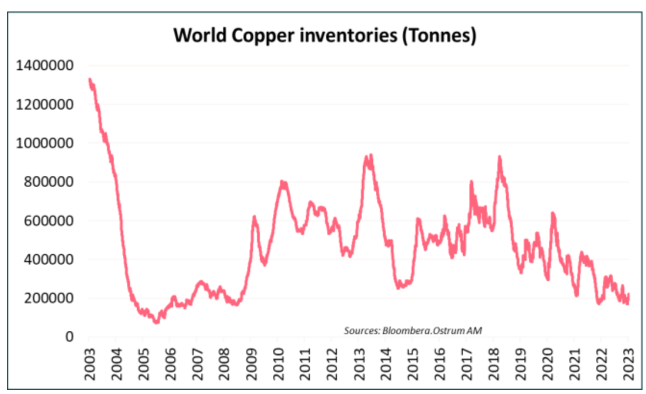


The prices of these metals had risen dramatically in 2020-2021, reflecting the desire to move towards sustainable consumption, as well as the distortions in supply chains linked to Covid-19. In 2022, prices fell, linked to fears of a global recession following the outbreak of war in Ukraine.

From the end of 2022, prices began to rebound in anticipation of the reopening of China. Zinc has recorded a performance of more than 10% since the start of 2023 and copper has passed the $9,000 per ton mark for the first time since June. Representing nearly 40% of global copper and zinc consumption and 35% for aluminium, China is therefore the main determinant of the prices of these metals.

In addition, other supporting factors could also support prices: the acceleration of the green transition in developed countries – to reduce their dependence on fossil fuels – and the Inflation Reduction Act in the United States which facilitates the green transition for American businesses.

On the supply side, inventories of many industrial metals are at low levels, reflecting weak investment in the sector. The chart below shows the level of global copper stocks which are at historic lows.



Copper, cobalt and nickel are crucial metals for the manufacture of batteries for electric vehicles, wind turbines and solar parks. **The problem is that the mining sector has an image of a "dirty" industry, whereas it is crucial in the fight against global warming. This is a considerable drag on investment in the mining industry, which should put upward pressure on prices.**

Conclusion

The planets are aligned so that 2023 is the year of raw materials. In terms of investment strategy, we continue to favor Latin America, particularly metal-producing countries such as Peru, the world's second largest producer of copper, silver and zinc, as well as the largest producer of gold and zinc from Latin America. These exports to China represent 8% of its GDP. The lack of visibility on its political situation leads us to favor Chile, a major copper producer whose exports to China represent 12% of GDP. The rise in metal prices should improve the terms of trade of these two countries, benefiting their currencies. Since the beginning of the year, the Chilean peso has been one of the top three emerging currencies that have recorded the best performances against the dollar: ruble (7.65%), Thai bath (4.76%) which benefits from the recovery of Chinese tourism and the Chilean peso (3.37%).

However, the opening of China raises fears of a return of inflation at the global level linked to the rise in commodity prices. For the moment, investors' inflation expectations remain stable, like the US 5-year inflation break-even point which no longer follows the rise in copper prices, as shown in the following chart. The question is until when?

Zouhoure Bousbih

Market review

Markets take a breather

Markets overreact to hopes of early monetary easing but central banks intend to stay the course

Financial markets are often driven by an optimistic belief of steadfast central bank support. Rapid disinflation, however limited to the price of goods, is supposed to pave the way for early monetary easing in the United States. This is the main reason for the strong appreciation of global risky assets since the beginning of the year. The rumor of a rise in the deposit rate of just 25bps next March, contrary to the communications of Philip Lane and Christine Lagarde, triggered a sharp decline in the yield on German 10-year Bunds below its natural floor of 2% and a knee-jerk burst in the EuroStoxx 50 equity index. Central bankers have not deviated from their hawkish message. The appreciation of risky assets logically moderated towards the end of last week. Profit-taking reflects the extent of the overblown rally in the first half of January and the lackluster economic publications in the United States. In Japan, the BoJ is playing hide and seek with market participants after the 10-year yield ceiling was raised to 0.50% last month. This monetary policy requires massive intervention on the JGB market which cannot be maintained indefinitely. The monetary status quo has created a bout of volatility in the Japanese yen, which may quickly resume its upward trend.

On the economic front, the latest US data releases depict a weakening of activity at the end of last year. Retail sales fell again by 1.1% in December after a weak November reading. Admittedly, the fall in the prices of consumer goods (energy in particular) amplifies the decline in nominal household expenditure, but the weakness of demand is indeed visible in most sectors. The regional manufacturing surveys of New York and, to a lesser degree, Philadelphia echo the drop in industrial production over the last two months of 2022. Growth in the 1st quarter will undoubtedly be weaker than the 2.5-3% growth estimate for the 4th quarter which is due out this week. In the euro area, the economy stagnated in the three months to December. However, the consumption of goods has slowed according to retail sales data. December inflation was confirmed at 9.2% year-over-year with core inflation still pointing upwards at 5.2%. On the other hand, GDP is likely to have contracted in the 4th quarter in the United Kingdom. The social backdrop weighed on consumption even if employment and wages remain upbeat.

The rise in financial asset prices is thus fueled by hopes of an early end to monetary tightening. Dovish expectations fed into 10-year sovereign yields which already trade nearly 50 bps below last year's close. The Bund yield made a brief foray below the 2% threshold before turning higher towards 2.15%. The yield curve remains quite inverted despite bond issues totaling a whopping $600 billion worldwide since the start of the year. Sovereign spreads are benefiting from the trend for lower yields so that last autumn lows failed to provide technical support. Italian BTPs are now trading within 180 bps against the backdrop of a broad-based narrowing of spreads. French OATs change hands at spreads below 45 bps. The €3.5bn syndication of 10-year Greek bonds, however, slowed this narrowing movement in the GGB market. In the United States, the debt ceiling has been reached, forcing the US Treasury Department to adopt extraordinary measures to avoid default. The recurring drama around the debt ceiling tends to add to US yield curve flattening. In this tense political context but also because of the procrastination of the BoJ on its yield curve control policy, the T-note yield traded as low as 3.32% last week. The 2-10 year yield spread hovers about at -74 bps at the end of last week. In addition, the outperformance of the US 5-year note, which highlights the directional nature of the latest market movement movement, resulted in the 2-5-10-year butterfly spread narrowing to -54 bps. In Japan, the BoJ is delaying its decision to raise the ceiling on 10-year JGB yields or abandon the yield curve control policy altogether. It only forces the BoJ to buy colossal amounts of JGBs. In December, the Bank bought the equivalent of 6 pp of GDP.

The downward trend in bond yields is all the more surprising as the primary market is breaking issuance records. More than $600 billion have already been auctioned this year across all sovereign and credit markets. While syndications at the start of the year are usual, the net supply flows expected over the coming quarters should weigh. It is the euro area that seems most vulnerable to increased refinancing needs by governments, financials and non-financial companies. So far, credit markets are easily absorbing the deluge of new issuance. The favorable flows into European credit funds and the level of cash in the funds at the start of the year may not be available in the coming quarters. The average euro IG spread narrowed by 9 bps in 2023 to 158 bps against Bund. The loss of momentum in the tightening of swap spreads, now stable about 60 bps on the 10-year Bund, is perhaps a first sign of indigestion. European high yield, where issuance is much more limited, posted a sharp spread tightening of 40 bps in three weeks' time.

Equity markets are taking a breather after a euphoric start to the year. The EuroStoxx 50, down last week, is still up 8.5% in 2023 despite the rise in the euro-dollar exchange rate. Banking, consumer staples and technology are the winning bets combining growth and value. In the US, high sales numbers thanks to the fall in the dollar (+7% on the first 55 publications of the S&P 500) do not fully offset the pressures on wage costs (banks, technology).

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	23-Jan-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.59%	+2	-6	-17
EUR Bunds 10y	2.2%	+3	-20	-37
EUR Bunds 2s10s	-39.4bp	+0	-2	-19
USD Treasuries 2y	4.21%	-2	-11	-21
USD Treasuries 10y	3.52%	+2	-23	-36
USD Treasuries 2s10s	-70bp	+4	-12	-14
GBP Gilt 10y	3.36%	-2	-27	-31
JPY JGB 10y	0.39%	-14	+3	+9
€ Sovereign Spreads (10y)	**23-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	45.35bp	-1	-9	-9
Italy	183.33bp	0	-30	-30
Spain	97.44bp	-1	-11	-11
Inflation Break-evens (10y)	**23-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.29%	+2	-21	-26
USD 10y Inflation Swap	2.47%	+7	-2	-5
GBP 10y Inflation Swap	3.62%	+7	-27	-29
EUR Credit Indices	**23-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	156bp	-5	-15	-11
EUR Agencies OAS	73bp	-1	-9	-6
EUR Securitized - Covered OAS	79bp	+1	-8	-5
EUR Pan-European High Yield OAS	468bp	-5	-58	-44
EUR/USD CDS Indices 5y	**23-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	80bp	+1	-13	-10
iTraxx Crossover	422bp	+6	-57	-52
CDX IG	73bp	+3	-8	-9
CDX High Yield	442bp	+18	-34	-42
Emerging Markets	**23-Jan-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	443bp	-9	-23	-10
Currencies	**23-Jan-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.085	0.277	2.213	1.4
GBP/USD	$1.233	1.115	2.298	2.0
USD/JPY	JPY 131	-1.690	1.621	0.3
Commodity Futures	**23-Jan-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$89.0	$4.5	$4.5	3.55
Gold	$1 913.8	-$2.2	$115.6	4.92
Equity Market Indices	**23-Jan-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 989	-0.26	3.74	3.9
EuroStoxx 50	4 135	-0.53	8.33	9.0
CAC 40	7 014	-0.42	7.82	8.3
Nikkei 225	26 906	4.20	2.56	3.1
Shanghai Composite	3 265	2.18	7.19	5.7
VIX - Implied Volatility Index	19.93	8.61	-4.50	-8.0

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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Final version dated 23/01/2023

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