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Spy balloon

On February 4, the US shot down a Chinese balloon which was suspected of conducting spying activities. The US government referred to this flying object as the spy balloon. This reignited the distrust and animosity between the world's two foremost economic and military superpowers. This latest conflict comes amid hotter-than-expected US inflation which spurred market expectations of higher interest rates and hawkish comments from Federal Reserve (Fed) officials.

Balloon wars

A balloon carrying surveillance equipment was first spotted in Alaska on January 28. The balloon made its way to Montana which houses intercontinental ballistic missiles and the anti-ballistic missile defense system of the US. These developments prompted US State Secretary Antony Blinken to postpone his first official visit to China. After days of contemplation, US President Joe Biden ordered the military to shoot down the balloon on February 4. Three other unidentified flying objects were likewise shot down for being suspected as Chinese spy balloons.

Cold war resumes

This dispute fanned the deep distrust, suspicion, animosity, and combative rhetoric between the US and China. The US blacklisted six companies that were tied to China's aerospace program. In retaliation, China imposed sanctions on Lockheed and Raytheon, two of the top American defense manufacturers. These moves sparked fears of a wider economic fallout.

The recent sanctions remind us of the full-scale US vs. China trade war during Trump's presidential term (see *It's official – the trade war begins*, July 9, 2018). It also brings to fore the escalating sovereign conflict between China and Taiwan, as well as the territorial disputes between China, the Philippines, and other ASEAN countries. In the ongoing war in Ukraine, the US accused China of siding with Russia because of their continued trade activities. The ideological divide seems wide as the US and China appear to be polar opposites in terms of politics, governance, and economic management. In addition, we have witnessed liberal/democratic countries that are banding together while various authoritarian regimes are seeking ways to cooperate. These present a brewing threat to global economic stability and growth.

Hawks claw their way back

Last week, the US reported that its consumer price index (CPI) rose 6.4% YoY and 0.5% MoM in January, beating expectations of 6.2% YoY and 0.4% MoM. Meanwhile, the producer price index (PPI) increased 0.7% MoM vs. the 0.4% estimate. In addition, US retail sales rose 3% in January while the unemployment rate is at 3.4%, the lowest since 1969. These have provided monetary officials the impetus for further rate hikes and the confidence that the economy is strong enough to withstand higher interest rates.

Cleveland Fed President Loretta Mester said that "the incoming data have not changed my view that we will need to bring the Fed funds rate above 5% and hold it there for some time." She added that she saw "a compelling economic case for a 50-basis-point increase" even before the release of the latest jobs and inflation data. St. Louis Fed President James Bullard believes that the Fed "should get to the level of rates the committee viewed as sufficiently restrictive as soon as we could." He added that "continued policy rate increases can help lock in a disinflationary trend during 2023, even with ongoing growth and strong labor markets." Fed Governor Michelle Bowman said, "I don't think anyone can argue that inflation is much too high… We're not finished yet. We haven't beaten inflation."

Like the US, the Philippines experienced higher-than-expected inflation in January (+8.7% YoY, +1% MoM) due to higher inflation in food and utilities. This prompted the Bangko Sentral ng Pilipinas (BSP) to hike its policy rate by 50 basis points last Thursday. In light of recent developments, the BSP also raised its average inflation projections for 2023/2024 to 6.1%/3.1% from 4.5%/2.8% previously.

King dollar reigns anew

News regarding the spy balloon, elevated inflation readings, and expectations of higher interest rates spurred the demand for the US dollar. Since the postponement of Blinken's China trip, the US dollar index (DXY) gained 2.1%, the Chinese yuan dropped 2%, while the peso fell 3.1%. As we have seen in the past, the US dollar rises every time there are military conflicts or heightened geopolitical tensions. This is because the US is the world's strongest military superpower and the largest economy in the world. It has the most liquid currency market because the US dollar is the primary global reserve currency. In times of uncertainty, the US dollar is king.

Bonds yields rise, stock prices fall

Since February 2, bonds prices have fallen sharply. The yield on the 10-year US Treasury climbed to 3.822% from 3.395%. The yield on the 2-year US government bond surged to 4.623% from 4.106%. JP Morgan's Marko Kolanovic said that the recent spike in the 2-year Treasury yield would imply a 5 to 10% slump in the Nasdaq100 if past market moves are anything to go by. Over the same period, the S&P 500 fell 2.4% while MSCI China, the Hang Seng Index, and MSCI Emerging Markets ETF (EEM) dropped by 6.7%, 5.6%, and 4.7%, respectively. The PSEi declined 3%.

Reemergence of risks

The recent market move was caused by elevated inflation, higher interest rates, and hawkish Fed speak. The spy balloon saga added another dimension of uncertainty as it renewed the tense relations between the US and China. This coincides with the ongoing Russia-Ukraine war and may have potential spillovers to global growth prospects. It is therefore crucial to monitor macroeconomic developments, central bank pronouncements, and important geopolitical events.

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