SMBC Capital Markets, Inc.

fxPoetry

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On the Schneid

All eyes now are turning to Jay
To see what, tomorrow, he'll say
Will he and his clan
Continue their plan
To keep taking money away?

Or is he now feeling the heat?
As pundits all over the Street
See growth on the schneid
While stocks start to slide
And that's ere the B/S retreat

Now one more thing, turning to gas
As Europe's now learning en masse
That policies 'green'
Though meant to be clean
Turn out to be filthy, alas

As the US session gets underway on the first day of the FOMC meeting, we are greeted with a bit more negativity than we saw last week. Arguably, the story with the biggest impact this morning is that Russia is taking yet another turbine off-line for maintenance at Portovaya pumping station which has reduced the NordStream 1 flow to 20% of normal. The EU response was to agree to reduce their natural gas usage by 15% next winter. Of course, the question is, which 15%? Industry? Home heating regulations? Electricity generation? NatGas is used in so many different applications that it seems the hard part is still ahead, figuring out just how to reduce usage. Of course, the upshot is that Europe will be burning a great deal more coal this winter to heat their homes and offices, ironically, increasing their carbon dioxide emissions dramatically. Apparently, despite fervent wishes that intermittent energy sources like wind and solar would be sufficient to power the economy, physics remains an implacable foe to the green movement. As a very wise green chicken (@DoombergT) is fond of saying, in the battle between platitudes and physics, physics is undefeated. (And you should all follow @DoombergT on Twitter)

The market impact, aside from NatGas (+3.0% in US, +10.9% in Europe) continuing its recent rocket-like behavior, is that the euro (-0.7%) is under serious pressure along with European equities (DAX -0.5%, CAC -0.2%, MIB (Italy) -0.5%) and, perhaps, not surprisingly, the key spread between Bunds (-8.4bps) and Italian BTPs (-4.9bps). 10-year Bunds are back below 1.00% yield for the first time since Memorial Day weekend and this all-important spread is back to 230bps, closing in on the level that seems likely to test Madame Lagarde's newest toy, the TPI. Above 250bps, it is quite clear the ECB is very uncomfortable and almost certainly will resort to its first BTP purchases under any guise at all. In addition, as long as the market continues to believe that Powell and the Fed are going to remain on the current hiking path, the euro is going to remain on its heels.

So, let's quickly pivot to the Fed and see how they're doing. Current market pricing is for a 75bp hike tomorrow after they quickly squashed the 100bp ideas in the wake of the CPI print two weeks ago. Then the market is looking for 50bp more in September and then a couple of 25bp hikes to round out the year in November and December. That would take Fed funds to 3.50%, above their current view of the long-term rate, but still well below any reading of either CPI or PCE. At that point, the market is now worried the US will enter a recession (if we haven't already) and that by June 2023, they will be cutting rates again.

In the meantime, a quick look at QT shows…nothing. Here we are in the last week of July, a full 2 months after QT was supposed to have begun and by which time the balance sheet was supposed to have been reduced by ~$95 billion, and after actually growing $4 billion last week, the balance sheet has shrunk by just $16 billion, a far cry from the $95 billion expected. The one truth the Fed has been willing to discuss is that they really don't have any idea exactly how shrinking the balance sheet is going to impact either the economy or markets. This begs the question if they had any idea how growing it would impact things, but that is a different story. My personal view has been that the relationship between balance sheet growth and asset price increases has been too tight for there not to have been causality. Thus, if the Fed were truly to allow bonds to mature without being replaced, I believe risk markets would suffer substantially, i.e., stocks would fall much further from here. I have a feeling we will not be hearing much about the balance sheet at all going forward as they will not have anything useful to discuss on the matter and are likely to hope nobody pays attention.

So, how are the rest of the markets behaving today? Equities in Asia were mixed with the Nikkei (-0.2%) sliding a bit while the Hang Seng (+1.7%) and Shanghai (+0.8%) both rallied on word the Chinese government is going to continue to add stimulus to the slowing economy there. We already discussed Europe except for the UK (FTSE 100 +0.5%) where it seems the idea that Liz Truss, the erstwhile Foreign Secretary, is set to become PM has been embraced by investors.

The only bond market we haven't mentioned are Treasuries (-4.0bps) as bond markets around the world are seeing inflows amid fear that equity markets might be setting up for their next leg lower. Certainly, the continued bad data from the US is not frightening the bond bulls at this point.

Not only is NatGas higher this morning, but so, too, is oil (+1.8%) as are base metals (Cu +2.5%, Al +1.2%) and food (Wheat +2.0%, Corn +2.1%, Soybeans +1.4%). In fact, in the commodity markets, only gold (0.0%) is lacking buyers on the day.

The dollar, which was definitely softer yesterday, has found its footing amid increased fears outside the US rather than increased optimism in the US. So, in the G10, as well as the euro, SEK (-0.9%), NZD (-0.5%) and GBP (-0.4%) are all softening pretty reasonably with only JPY (0.0%) able to retain its value today. Ultimately, this continues to be the USD is the cleanest dirty shirt in the laundry. EMG currencies are mostly weaker as well with the CE4 (HUF -0.9%, PLN -0.8%, RON -0.7%) leading the way on the back of the euro's decline, while APAC currencies had a bit more mixed session with the laggards falling only slightly and two powerful positive stories, PHP (+1.4%) which rose sharply after the central bank promised more rate hikes and KRW (+0.4%) which rallied on equity investor inflows after GDP data there surprised to the upside.

It's another day of secondary US data with Case Shiller Home Prices (exp 20.6%), Consumer Confidence (97.0) and New Home Sales (659K), none of which seem likely to drive markets. While the Fed starts its meeting, we only hear from one ECB speaker, de Cos, who is scheduled to discuss inflation. It could be a long discussion, no?

While the economic situation in the US remains fraught, my observation is that the situation elsewhere remains even more dire, especially in Europe as the combination of energy pressures and Italy's home-grown problems are proving very difficult to address effectively. In the end, the ECB seems likely to do what it always does, print more money, and that cannot be a benefit for the single currency. I maintain it has further to fall with the caveat that if somehow, Powell sounds dovish tomorrow, we could see a reversal.

Good luck and stay safe
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