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fxPoetry

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The BOJ Waits

Despite all the signs
That inflation's persistent
The BOJ waits

Fortunately, very little seems to have changed while I was on holiday, or…

It seems that there are three big themes in markets lately and one in macroeconomics. First, there has been a remarkable amount of discussion regarding the yen's ongoing weakness and how the BOJ, despite having reiterated last week that they are standing pat with respect to YCC, is ultimately going to have to blink. The news this morning is that foreign investors were selling JGB's hand over fist last week and that now the BOJ owns >50% of all JGBs outstanding. While the yen is little changed this morning from Friday's closing levels, given the ongoing rhetoric from the Fed, talking about a strong economy and the need to continue raising rates, even if it leads to a recession, and the BOJ's insistence that inflation in Japan is not of the persistent variety and therefore they have not yet achieved their goals, there is no indication that the yen is about to change its direction of travel. Year-to-date, the yen is weaker by nearly 15% vs. the dollar and as we have heard numerous times, it is at its weakest point since 1998, but until either Chairman Powell or Kuroda-san blinks, there is no reason to believe this will change.

However, when either of those things change, and my money is on Kuroda going first, be prepared for some real fireworks. Once again, a favored trade in the market is the so-called 'widowmaker' of being short JGB's. The JGB futures market has already disconnected from the cash market and is much weaker. But this trade has earned that sobriquet for having been incorrectly called since sometime in the 1980's with numerous high profile investors having lost huge sums of money on the trade. The key issue here is that when it changes, if the position is not already in place, there will be no opportunity to take advantage of what is likely to be an extraordinary move. JGB yields could easily rise 100bps in minutes and USDJPY could fall 5% in the blink of an eye. The problem is the carry on the trade is highly negative, so timing is everything. Will this be the time when policy begins to normalize in Japan? If pressed I would say yes, before the end of 2022 we will see things change.

The stock market rally is great
As long as it doesn't abate
But don't get too cozy
That everything's rosy
'Cause bear markets, bulls, immolate

The second market story is about the recent rebound in equity prices and the question of whether the bear market has ended. The answer to this is simple, NO! Two key things to remember about bear markets are 1) there is always a capitulation trade which leads to 2) in bear markets, nobody is even thinking about a place to buy stocks, the only sentiment is to sell. Looking at price action over the past several months, what we have seen is a steady sell-off in the stock market without real volatility and limited fear. While I believe those things are going to show up, until they do, this is simply a weak market. As well, there are more stories in the press about which stocks one should buy in order to take advantage of the rebound. In bear markets, the press focuses on why stocks are no longer a good investment and cocktail party chatter is focused on things other than how much money one made on the latest hot investment. This is a classic bear market rally, which historically are quite fierce, but don't change the situation. Until circuit breakers are triggered, and likely more than once, we have not yet seen the bottom.

The third market story is more entwined with the macro story, and that is, have commodities peaked because we are heading into a recession? In my view, this answer is more nuanced but essentially as follows: medium- and long-term trends in commodities remain higher as a decade plus of capital starvation has assured a structural supply shortage of important things like oil, NatGas, copper and uranium, However the short-term outlook is less promising given what appears very much like rapidly slowing growth around the world as economies everywhere start to cope with much tighter global monetary policies. Chairman Powell was quite clear that while the Fed was not forecasting a recession, one is possible as a result of their efforts to quell inflation. Meanwhile, Madame Lagarde is dealing with a much bigger problem as the Ukraine war has caused serious disruption in European energy acquisition with talk now that Russia will turn off the natural gas pipelines this winter, an outcome that would be both an economic and humanitarian disaster. In this environment, short-term demand for commodities is likely to suffer, but that will be a temporary situation and there is exactly zero indication at this stage there will be sufficient investment going forward to increase supply.

Summing it all up, there is no reason to believe that central banks are prepared to change their policy stances yet, which means the broad trends of dollar strength and higher rates, as well as weaker equity prices seem likely to continue. As well, a recession seems almost a given, if it is not already here, which bodes ill for commodities in the short run as well as stocks. Meanwhile, the dollar will continue to dominate right up until the Fed turns its policy around, at which point we should see a significant reversal to levels more like 1.20 in the euro and 110 in the yen.

But now its time for today's markets. The rally continues as green is the only color on my screens. Overnight saw the Nikkei (+1.4%), Hang Seng (+2.4%) and Shanghai (+0.9%) all continue the recent trend with the PBOC just coming out and reiterating their support via monetary policy for the Chinese economy. European bourses have been a bit less ebullient (DAX +0.8%, CAC +0.1%, FTSE 100 +0.6%) but still all good. And US futures, after a slam-bang day on Friday, are all pointing higher by between 0.2% and 0.75%, although those levels are off early session highs.

Bond yields are much higher this morning as any ideas of recession led declines seem to have been forgotten. Treasury yields (+3.9bps) are actually holding up relatively well compared to Bunds (+10.8bps), OATs (+11.8bps) and Gilts (+8.8bps) with Italian BTPs (+12.2bps) the worst of the bunch. Remember, the market is still counting on some magical tool from the ECB to prevent fragmentation, which is the latest euphemism for a widening of the yield spreads between the PIGS bonds and German bunds. That magical tool is the ECB will buy BTPs and potentially sell Bunds in order to prevent things getting out of hand. They will simply try to call it something else.

On the commodity front, oil prices remain quite volatile overall, having seen a more than 15% decline in two weeks, but have since rebounded somewhat and are little changed today, up just 0.2%. NatGas (-1.4% in the US, +0.6% in Europe) is even more volatile as the fire at one of the seven LNG liquification plants in the US has altered the short-term supply characteristics with lots more gas in the US and lots less being exported hence their changing fortunes. However, you can be sure that once the damage is repaired, which is likely to take another two months, these recent moves will reverse. As to gold (+0.7%) it retains its haven characteristics and while not appreciating seems unable to decline as well. However, industrial metals (Cu +0.3%, Al +0.25%) though modestly firmer today are responding to (leading?) the story about recession.

Finally, the dollar today is very modestly softer with SEK (+0.5%) and the euro (+0.3%) the leading gainers in the G10. However, both of these look to be ongoing consolidation of longer-term trends rather than changes in those trends. The rest of the bloc is little changed. EMG currencies, though, are having a bit better go with TRY (+1.2%), KRW (+0.9%) and THB (+0.5%) all performing well amid broader based dollar weakness. The lira is continuing to respond to changes in Turkish banking regulation regarding the ability of Turkish banks to make lira loans to companies with significant deposits in FX, while the won benefitted from the overall positive risk sentiment and equity investor inflows, as did the baht. Just be wary of all these currencies when the current positive mood dissipates, and it will.

There is some important data this week, including the PCE data as well as a number of Fed speakers.

Today	Durable Goods	0.2%
	-ex Transportation	0.3%
	Dallas Fed	-6.5
Tuesday	Case Shiller Home Prices	21.20%
	Consumer Confidence	100.0
Wednesday	Q1 GDP (Final)	-1.5%
Thursday	Personal Income	0.5%
	Personal Spending	0.4%
	Initial Claims	230K
	Continuing Claims	1310K
	PCE Deflator	0.7% (6.4% Y/Y)
	Core Deflator	0.4% (4.8% Y/Y)
	Chicago PMI	58.0
Friday	ISM Manufacturing	54.7
	ISM Prices Paid	80.0
	Construction Spending	0.4%

Source: Bloomberg

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The views expressed are his own and may differ from Research.

While all eyes will be on the PCE data, at the press conference following the FOMC meeting two weeks ago, Powell indicated they would be looking at headline CPI as well, so this may have lost some of its importance. Meanwhile we hear from a few Fed speakers including Chairman Powell on Wednesday at the ECB's big summer event in Sintra Portugal.

At this point, while we continue to see a risk-on view in asset markets, the dollar seems to be less inclined to sell off than might be expected. But I would argue that relative monetary policies are still the number one driving force in the FX market, and until those policies change, the dollar's bias will be higher. Just watch out when they do!

Good luck and stay safe
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