SMBC Capital Markets, Inc.

fxPoetry

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Yesterday's News

Though fears of recession are high
Chair Powell is quick to deny
That problems exist
So, he will persist
In raising Fed Funds to the sky

Investors, though, have other views
As they try, Jay, to disabuse
Of his silly notion
His recent devotion
To rate hikes ain't yesterday's news

The rubber, as they say, is meeting the road these days as the Fed, ECB and BOE all try to cope with substantial inflation alongside evidence of slowing growth. While only the Fed has the true dual mandate, maximum employment and stable prices, one needs to go back to the pre-euro days when the Bundesbank ruled Europe, to find a central bank that was solely concerned with prices and their trajectory to the exclusion of all else. The point is, the ECB and the BOE, though nominally focused on inflation, are keenly aware of economic activity and extremely reluctant to adjust policy such that growth would decline.

Alas, those three central banks are now in a situation where more than a decade of ultra-loose monetary policy combined with massive covid-inspired fiscal policy stimulus has resulted in the general price level rising rapidly. Adding to the problem is the impact of the Russian invasion of Ukraine and its impact on both food and energy prices due to the severe reduction in supply of both. The central bank playbook is quite clear what to do about rising prices; raise rates. Alas, in that same playbook, it describes raising rates as the policy best suited to slow economic activity. Now that more and more signs are pointing to a recession in the US and Europe, which may have already begun, these central banks are going to have an extremely difficult time squaring this circle.

This is brought to the fore today as at 2:00pm EDT we will see the FOMC Minutes from the June meeting where Powell and company raised the Fed Funds rate by 75 basis points, its largest single move since 1994. At that press conference, Powell explained the economy was strong and could withstand higher interest rates, and they would not allow inflation expectations to rise. That attitude is so three weeks ago! In the interim, we have seen enough weak US data to drive the Atlanta Fed's GDPNow forecast for Q2 to an extremely precise -2.078%. If this is accurate, that would result in two consecutive quarters of negative GDP growth, the widely accepted definition of a recession. That seems at odds with Powell's description of the economy as strong, but perhaps I don't understand the nuances of being a central banker. After all, I am just an FX guy.

Yesterday I made the point that it is not clear the Minutes are really that useful anymore, especially in a situation like today where we have seen dramatic changes in markets as well as a raft of data in the ensuing period, and more importantly, we have heard from nine of the FOMC members across 21 different speaking engagements. And these are just the scheduled engagements and don't include interviews on CNBC or Bloomberg TV. I would argue they have already told us what they were thinking back in June, and if their views have changed, we would have heard that as well.

And what we have heard consistently is that the focus of the FOMC remains entirely on inflation. While both the Fed funds and Treasury markets are now clearly pricing in lower interest rates by the middle of next year, there has been no indication that the Fed has lost its focus. This matters a great deal because the impact on market prices is likely to continue to be significant. Yesterday we saw some remarkable movements as not only did the dollar race higher against all its counterparts, with the euro declining nearly 2%, but we saw oil prices suffer a dramatic decline of nearly 10% on the idea that continued Fed tightening will lead to a recession and a significant decline in oil demand. In fact, all commodity prices collapsed yesterday, although they have found some stabilizing support this morning. Interestingly, equity markets are not really sure what to do, as we have seen both weakness and strength depending on which country one observes. The one unifying theme is that price volatility remains elevated in most every market and market liquidity remains shallow. Keep that in mind when considering any hedging needed.

Ok, so now that we have covered the Fed's conundrum, how are markets behaving this morning? Overnight we saw broad equity market weakness in Asia (Nikkei -1.2%, Hang Seng -1.2%, Shanghai -1.4%), but in Europe, it is the exact opposite (DAX +1.4%, CAC +1.6%, FTSE 100 +1.7%). The FTSE 100 is most interesting given that the political situation in the UK has become murkier even than in the wake of the recent no-confidence vote in PM BoJo. Yesterday, two key cabinet members, including Chancellor Rishi Sunak, resigned with numerous junior ministers leaving as well. And while the pound (-0.25% today, -1.5% since Monday) is clearly under pressure, it appears equity investors are quite optimistic. Perhaps they believe that a change in leadership will be a positive. As to the US, yesterday saw early sharp declines and then a reversal such that the NASDAQ actually closed higher on the day by nearly 2%, although I suspect there was some short covering involved. This morning futures are flat to slightly lower as we await the ISM Services Index (exp 54.0) as well as JOLTS Job Openings (10.9M) ahead of the Minutes.

The bond market can fairly be described as mixed this morning with Treasury yields slightly higher (+0.7bp) along with Bunds (+0.4bp) and Gilts (+2.1bp) but OATs (-0.5bp) as well as BTPs (-1.1bps) are slightly lower. Much is being made of the very slight inversion in the 2yr-10yr Treasury curve, which is just 2 basis points right now, but given the increased recession talk, we are likely to continue to hear about this. Remember, though, as a harbinger of recession, curve inversion typically occurs between 12 -18 months ahead of the recession. At this point, more and more evidence is pointing to the recession starting very soon, if it hasn't already begun.

Commodity traders were carried out on stretchers yesterday amid wholesale destruction in markets. Oil prices (+0.6%) fell 10% yesterday, having been down as much as 12% before the session closed. NatGas (+2.4%) also fell sharply, down 7.6% having been down as much as 10% in the early morning session before rebounding slightly. The funny thing about this is that there is exactly zero evidence that supplies of these critical products is going to be increased anytime in the future, especially in Europe, and the situation there is actually so dire that governments throughout the EU are discussing contingency plans for rationing Natural Gas in the upcoming winter. There is great concern, justified in my view, that Russia may simply turn off the taps and Europe, especially key industries like fertilizer, aluminum and glass production as well as steel and autos, may find themselves in quite untenable positions if that is the case. The WSJ had an excellent article on the subject this morning. It seems the European model of importing cheap energy and creating value added products may be coming undone as the cheap energy part of the equation is torn asunder. It is no wonder the euro is under so much pressure.

Speaking of the euro (-0.7%) it has just broken below 1.0200 and seems hell-bent on getting to parity post haste. In fact, the dollar continues to rip higher this morning against virtually all its counterparts in both the G10 and EMG markets. In fact, only JPY (+0.3%) is firmer today, perhaps on a risk-off sentiment, but elsewhere in the G10 weakness is universal, albeit not quite as dramatically as yesterday. In the emerging markets, HUF (-1.7%) is leading the way lower followed by PLN (-1.4%) and TRY (-1.4%) with a long list of currencies down by between -0.5% and -1.0%. The thing is, there is no need for an idiosyncratic story to drive this movement as it is simply a broad-based USD rally. Until we hear from the Fed that they are concerned about growth and may reconsider their current uber hawkishness, I see no reason for the dollar to reverse course. But when they do…be careful! That reversal will be epic. For now, though; buy dollars, wear diamonds!

Good luck and stay safe
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