SMBC Capital Markets, Inc.

fxPoetry

July 7, 2022

Andrew Fately
Executive Director, Senior FX Marketer
Global Markets Marketing Department
andrew_fately@smbcgroup.com
Direct: +1 212-224-4532
Representative: SMBC Capital Markets, Inc.

Partisan Hue and Cry

To Boris, we now say good-bye
Amid partisan hue and cry
His time as PM
Defined by mayhem
Showed adults were in short supply

The word is, later today, UK Prime Minister Boris Johnson will succumb to the growing pressures and resign from office. The latest scandal, where he lied about his knowledge of an appointee's previous sexual harassment issues, was the last straw. While he will continue to manage a caretaker government, it appears his political career may be ending. The process to elect a new Tory leader could take a number of months which means that UK fiscal policy is likely to fade as a force leaving the BOE as the driving impetus in the UK economy and markets. This begs the question of whether BOE Governor Andrew Bailey is up to the task of fighting 11% inflation by himself. My money is on 'No', which implies to me that the pound has further to decline. Perhaps not immediately as there will be a relief rally, but over time.

The Fed promised everyone they,
To keep high inflation at bay,
Would show their resolve
Which could well involve
Restrictions from which they'll not stray

The other key story is, of course, the Fed and its ongoing struggles to temper rising prices with tighter monetary policy. Yesterday's release of the Minutes of the June meeting, where they raised rates 75 basis points, were in keeping with their recent rhetoric of an unwavering focus on inflation. In fact, the word count of the Minutes showed 90 references to inflation and 0 (zero) to recession. The key quotes were, *"Many participants judged that a significant risk now facing the committee was that elevated inflation could be come entrenched if the public began to question the resolve of the committee*," and *"they recognized the possibility that an even more restrictive stance could be appropriate if elevated inflation pressures were to persist*." Certainly, they are talking tough.

Perhaps more interestingly has been the markets' collective response to this news. While we basically had the Fed explain that they will gladly trade a recession for inflation, equity investors saw this as good news and stock prices have been consistently gaining for the past several days. My confusion comes from the fact that in a recession, earnings tend to fall dramatically. In addition, price/earnings multiples tend to fall to their cyclical lows, well below current levels, which means that equity prices tend to fall very significantly. And while we have seen declines on the order of 20% from the peak so far, that has not been nearly enough to erase the extraordinary excesses that we have seen since the GFC and especially since the Covid response.

Ours, though, is not to reason why…no wait a minute, that is exactly our goal. The best I can figure at this time is in the short-run, market participants are relieved that the Fed, and perhaps some other central banks, look to have their focus on inflation and preventing any further rise thereof. As inflation is a long-term, insidious problem for both economies and markets, this renewed confidence in central bank actions is playing out as a re-embracement of risk with equities in favor and bonds getting sold. Commodities, too, have come under intense pressure as the combination of recession expectations and a stronger dollar, both the result of those tighter policy expectations, are taking their toll.

Short-term market moves can be both perverse and last a little longer than you think. But the long-term situation, especially regarding commodities has not changed. The world is structurally short energy, especially oil, and while a recession might temporarily allay that issue, it won't solve it. The world is also structurally short many important industrial commodities like copper, nickel, cobalt and lithium, all of which are critical for the anticipated electrification of everything. While prices for these substances may have fallen recently, the longer-term picture remains quite constructive and will eventually reassert itself. And of course, that will have important consequences for inflation in the long-term. My point is, I believe the big trends toward higher commodity prices and higher inflation remain intact, although in the short run, things could well be different.

Ok, so how exactly have markets performed? Well, equities in Asia (Nikkei +1.5%, Hang Seng +0.25%, Shanghai +0.25%) were all in the green, although Chinese equities seem marginally disappointing based on the news that China is going to allow an additional $220 billion of borrowing by local governments to expand infrastructure spending (which will need more commodities). Europe, (DAX +1.65%, CAC +1.55%, FTSE 100 +1.3%) is also completely green, although certainly not on the back of any data. Of course, the UK is benefitting from the relief rally over Johnson's imminent resignation, but the continent has no such positivity. Arguably, investors here are responding to the positive signals from the US as well as hope that the ECB can tame inflation. Finally, US futures are all pointing higher by about 0.3% at this hour, continuing their rally from yesterday.

Bond markets, on the other hand, have seen a complete lack of buying interest with yields higher across the board. Treasuries (+1.1bps) have actually moderated since earlier in the session, but the same cannot be said for Bunds (+8.1bps), OATs (+8.1bps) or Gilts (+3.7bps). Of more concern to the ECB is the fact that BTPs (+14.3bps) are seeing their yields widen vs. Bunds, exactly the opposite of what recent ECB discussion has been trying to achieve. That spread is back to 200bps, the level at which the ECB becomes very nervous. Also, of note here is that the US yield curve has inverted with 2yr yields 7bps higher than 10yr yields. Once again, this harbinger of a recession is on minds everywhere especially given the recent data weakness that has broadly been seen.

On the commodity front, oil (+0.9%) is stabilizing after a couple of absolutely dreadful days, and NatGas (+1.6%) seems to be doing the same thing. In fact, NatGas in Europe (+3.8%) and the UK (+6.9%) continues its march ever higher as concerns grow over whether Russia will stop deliveries come the winter. In the metals markets, which have also seen sharp declines, gold (+0.3%) has arrested its recent decline, at least for now, and copper (+3.4%) and aluminum (+0.6%) seem to be responding to the Chinese infrastructure spending plans.

Finally, the dollar, which has been on a tear recently, is taking a respite, with 9 of the G10 stronger led by AUD (+0.8%) and NZD (+0.5%), benefitting from the general mood as well as the commodity price rally, and only CHF (-0.1%) showing any weakness as havens seem out of favor today. In the emerging markets, MXN (+0.5%) and KRW (+0.5%) are the leading gainers followed by ZAR (+0.4%). The peso is clearly benefitting from the commodity story as well as broad-based dollar weakness, as is the rand. The won saw buyers after trade data returned to a surplus and equity inflows materialized, especially with a very good earnings report from Samsung. On the downside, PHP (-0.7%) was the laggard, falling after the FinMin explained economic growth there may lag initial estimates, while HUF (-0.45%) fell despite a surprise 200bp rate hike by the central bank. It seems that concerns are growing over whether President Orban's government is ever going to get its subsidies from the EU, a situation which would have a very detrimental impact on the economy there.

Today's data brings ADP Employment (exp 200K), Initial Claims (230K), Continuing Claims (1328K) and the Trade Balance (-$84.7B). With payrolls coming tomorrow, and the Fed essentially telling us they will accept a recession, it strikes that this data would have to be extraordinarily awful to change any views, at least for today. However, if the data keeps pointing toward a deepening recession in the US, the market will continue to look for the Fed to reverse course early next year, regardless of where inflation sits.

As to the dollar's future, for now, though it is softer today, there seems little reason to believe it will stop climbing during the next several months, at least.

Good luck and stay safe
Adf