SMBC Capital Markets, Inc.

fxPoetry

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Inflation is Hard

No matter what central banks say
Inflation's not yet gone away
The latest surprise
Was Deutsch PPI's
Which rose like a rocket today

The problem for Madame Lagarde
Is fighting inflation is hard
If rates go up quickly
Then growth will be sickly
And her future will be ill-starred

In a truly shocking data outcome this morning, German PPI rose 5.3% in July on a monthly basis, a tad more than the 0.7% expected by economists, with the result that the Y/Y number is now 37.2%! This is the largest single month rise in the statistic since records began in 1975. And while it is true, the outcome was a result of the extraordinary rise in energy prices, it doesn't make it any easier to swallow. As well, given the ongoing Ukraine war and the very real possibility that Germany cuts the flow of natural gas to Europe completely as winter approaches, there is nothing to prevent these energy prices from rising still further.

One obvious issue is that the profitability of German industry is being decimated, so much so that companies are considering leaving Germany to find countries that have a less costly infrastructure. Either that or they are simply closing down as they can no longer operate in a profitable manner. Consider that Germany's industrial powerhouse reputation was originally built on the back of its abundant coal resources which morphed into a reliance on cleaner, cheap Russian natural gas. If that ingredient is missing, the underpinnings of Germany's strength become much shakier. Alas for the good people of that country, there is very little they can do to correct the situation these days as they have lost control of their energy supply. This is the reason we hear more and more about rationing of electricity and gas, why coal-fired power plants are being restarted and why firewood prices have more than doubled as people try to prepare for the winter.

Not surprisingly, none of this is seen as a positive for the nation and investors have been exiting German assets for the past year. During that time the DAX has fallen 16.5% (and that is after its recent rebound since June), Bund yields have risen more than 150 basis points and the euro, of which most people consider Germany to be the most important part, has declined by nearly 14%. It continues to be very difficult to paint a picture of near-term strength for any European asset as the entire continent is being dramatically and negatively impacted by the extraordinary rise in energy prices and the concomitant rise in inflation. Add to this a central bank that has proven itself to be, not only miles behind the curve, but completely impotent to address the key issues, and it is easy to paint a picture with the euro well below parity despite rising European sovereign yields.

Of course, it is not just the ECB that is having problems, virtually every central bank is behind the curve as I demonstrated yesterday with the table of real interest rates in the G20. (As an aside, who would have ever thought that Argentina's monetary policy would be tighter than that in the G10? At least as measured by real interest rates.) A quick look at the BOE shows a central bank with interest rates currently at 1.75% and inflation at 10.1% and forecast to peak at 13.1% later this year. But at least the BOE has admitted to the situation and vowed to fight it. The Fed, meanwhile, has a much bigger problem; it seems very few market participants believe their words.

Yesterday we had four more Fed speakers come out and reiterate what they have been trying to say ever since the July FOMC meeting. That message is not only is there more tightening of policy than currently priced, but that the idea of a pivot is completely off base. At this point, parsing the Fed message, I see the following: we are going to raise rates at least another 100bps by the end of the year and possibly more in 2023. As well, we are going to maintain rates at that level for as long as it takes until we are convinced that inflation is not merely retreating, but that it is going to remain back at much lower than current levels. Oh yeah, and if that means a recession, so be it!

Yet the market continues to price a high in Fed funds of 3.69% next spring and rate cuts within 6 months of that time. It is this attitude that has underpinned the rebound in the equity market as investors (and algorithms) are willing to 'look through' the bad news to the unbelievably bright future and the next big bull market.

On the one hand, given the Fed has a history of caving to inflation when growth starts to decelerate, with only one exception, Paul Volcker, it is easy to understand the market's point of view. However, virtually every market participant has only ever known an economy with very modest inflation so the risks for the Fed were asymmetric, recession was the bigger problem. Now, though, with inflation at 40-year highs, those risks are no longer biased toward growth at all costs. It remains to be seen if Chairman Powell has the courage of his convictions, and perhaps we will learn more next Friday morning when he speaks at the Jackson Hole Symposium, but on the surface, the Fed appears to be preparing to be far more aggressive in their policy tightening than the market is expecting. If they hold that line, there will be much more adjustment to risk profiles going forward.

Aside from the German PPI data, there was not too much else of note overnight and though concerns seem to be growing this morning, that was not the case at the beginning of the session. So, Asian equity benchmarks were flat in Japan and Hong Kong although Shanghai (-0.6%) was a harbinger of European price action. In Europe, the DAX (-0.9%), not surprisingly is leading the way lower with the CAC (-0.7%) and the FTSE 100 (-0.1%) following. In the UK, two data points gave opposite impressions with GfK Consumer Confidence falling to -44, its lowest print ever, although Retail Sales in the UK rose 0.3%, far better than the expected -0.2%. In the US, futures are pointing definitively lower, around -1.0% at this hour, as there is no data to come, thus only bad vibes from more speakers.

In the bond market, inflation is clearly the fear today as yields are higher around the world. Treasuries (+6.4bps) are pushing back toward 3.0% while Bunds (+11.3bps), Oats (+12.1bps), Gilts (+13.2bps) and BTPs (+17.3bps) are all being tossed aside in a hurry. Of concern to the ECB will be the fact that the Bund – BTP spread has widened out to 227 basis points, creeping closer to what is perceived as the danger zone of 250bps.

On the commodity front, oil (-2.1%) has fallen after yesterday's rally and NatGas (-2.3%) is also retreating from its recent rise. Gold (-0.45%) continues to suffer on the back of USD strength while copper is flat on the day. Overall, it appears that most risk assets are under pressure today.

Finally, the dollar is universally stronger this morning, rising against all its G10 brethren with NZD (-1.0%) the worst performer followed by both the yen (-0.8%) and pound (-0.8%) with the former clearly feeling the pressure of the higher US yields while the latter is concerned about that GfK number. In the EMG bloc, PLN (-0.9%) is the laggard, although ZAR (-0.8%) and MXN (-0.65%) are also softer but the story seems to be US rates rising and the dollar generally stronger rather than anything particular to these currencies. However, every currency in the bloc is lower this morning.

There is no US economic data on the calendar today and arguably, aside from Richmond Fed President Barkin's speech, the biggest issue is that it is option expiration day in the equity market so the chance for some further equity volatility is elevated.

As long as US rates are pushing higher, that bodes well for the dollar's future, and with the Fed adamant that they are going to continue to tighten policy, you have to like the dollar going forward.

Good luck, good weekend and stay safe
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