SMBC Capital Markets, Inc.

fxPoetry

July 29, 2022

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Given Short Shrift

Regardless of how it's defined
The GDP data declined
Thus, traders are sure
The Fed's only cure
Is rate cuts can't be far behind

The impact on markets was swift
With risk assets getting a lift
But so did the yen
As yields fell again
And yen shorts were given short shrift

It has been quite an interesting week in markets around the world as the underlying key narrative has shifted dramatically. Not surprisingly, markets have responded as well with some pretty significant movement. You may remember that prior to the FOMC meeting this past Wednesday, the theme of most market discussions was about how aggressive the Fed was going to be and how high they may raise interest rates in their effort to curb a powerful inflationary pulse. Forty-year highs in CPI readings was on everybody's lips and expectations were for a certain 75bp rate hike with a chance for 100bps. And there seemed no end in sight. After all, the Fed's own Dot Plot showed they expected Fed funds to be at 3.75% next year with 5 FOMC members expecting rates > 4.0%. Given we are still at 2.5% even after their Wednesday move, it seems like there is a lot left to come. Not only that, but there are many who argue that 4% will not be enough to tame the current inflationary impulse, and that demand destruction will need to be far greater, thus rates higher, in order to achieve victory in Powell's primary fight against too-high inflation. In addition, given the political pain that is being felt by the administration, they clearly back him in this effort.

But that narrative has been tossed aside like a dirty diaper. In the wake of his dovish(?) press conference and yesterday's negative (-0.9%) GDP print, the markets collective wisdom has now determined that the future is bright because the Fed will never lift rates quite so high and therefore risk assets are cheap.

A quick look at the Fed funds futures market shows that the changes there have not been that dramatic, certainly not as dramatic as the equity rally. Prior to the FOMC meeting, the futures market was pricing peak Fed funds at 3.39% come December with an expected first 25bp rate cut in June. This morning, peak Fed funds are priced at 3.26% with that first cut coming in either May or June. Thirteen basis points doesn't seem like that big a difference, but then, dovishness is in the eye of the beholder.

What of the recession? Well, leaving the description of the economic situation aside, the reality is that growth in the US appears to be slacking off, and has been for a while. The earnings season has been mixed, with some strong numbers and some weak numbers, at least relative to the consistently reduced Wall Street expectations. But one thing that can be gleaned from the data is that companies are continuing to raise their prices in order to cover their rising costs, and that the dollar value of sales, if not the volume of goods/services sold, continues to rise. Of course, that is the very definition of inflation, and exactly what Chairman Powell is trying to fight. And inflation is not merely a US phenomenon, as we saw last night in Japan (Tokyo CPI ex fresh food at 2.3%) and this morning in Europe (CPI at 8.9% vs 8.7% expected). While I grant that energy prices have fallen from their absolute highs, they continue to be much higher than they were 12 months ago, and price pressures remain significant. It strikes me that the market may be a little ahead of itself in estimating rate cuts so soon.

In fact, if we listen to what Powell and Yellen have said, the US economy remains strong and needs to slow down, thus higher rates are necessary. We are getting the same message from Europe (ECB's Kazaks and Vizco), that inflation remains a key priority. I would be wary of believing this down cycle has ended. Neither the facts on the ground nor the price action convince me that the end has been reached. Bear market equity rallies are some of the fiercest types of rallies, and to my eye, that is exactly what we are seeing here.

On a related note, a quick word about the yen, which has put in a monster rally this week, rallying more than 3% and more than 5% from its mid-June nadir. This rally, until today actually, has been completely in sync with the decline in Treasury yields, but also, has been fostered by the closing out of massive yen short positions in the market. Prior to the narrative change, when expectations were for US rates to continue to march higher and yen rates to remain capped, shorting the yen was an easy call, and you got paid to carry the position. But as the narrative changed, so did conviction in that trade. I expect that when the CFTC data comes out next week (showing this week's position changes) we will see a much reduced net short position. Is the long-term yen weakening trend over? I doubt it, but that's not to say we can't get back to 130 while the current story drives things. However, as we go forward, if the Fed continues down its hawkish path, raising rates and pushing to keep inflation down, I expect that we will see the yen turn back lower.

Ok, a quick tour overnight showed that Asian markets did not share the US enthusiasm with the Nikkei (-0.1%) the best performer and the Hang Seng (-2.3%) and Shanghai (-0.9%) both selling off. Europe, though, has embraced the good news of higher inflation and too-low interest rates (?), or something like that with equity markets across the continent rising (DAX +1.1%, CAC +1.4%, FTSE 100 +0.4%). And not to be left out, US futures are all higher at this hour with the NASDAQ (+1.1%) leading the charge.

Treasury yields have rebounded slightly, +1.8bps, but are still below 2.70% while European sovereigns are being sold as investors flock to equities there so yields are higher across the board (Bunds +6.5bps, OATs +5.7bps, Gilts +7.4bps) except in Italy, where BTP yields (flat) have narrowed that all important gap with Bunds. Arguably, the fact that Italian CPI was ‘only’ 8.4% in July is helping the story.

Oil prices (+2.3%) are leading the commodity space higher with NatGas (+1.0%) following along as well. Metals markets are also bid (Au +0.3%, Cu +1.0%) and food prices are higher as well. In other words, risk is on!

Finally, the dollar is generally, though not universally weaker today as markets both price in lower US rates ahead as well as square up into the weekend. In the G10, JPY (+0.7%) is leading the way followed by NOK (+0.5%) which is clearly benefitting from oil’s rise. The laggards are CAD (-0.25) and the Antipodeans which are just barely softer. But in truth, this movement does not appear fundamental in nature. EMG currencies are mostly stronger led by PHP (+1.25%) last night on the general positive vibes from less Fed hawkishness. We also saw IDR (+0.7%) and INR (+0.6%) follow suit on the same basis.

There is a bunch of data this morning, starting with Personal Income (exp 0.5%) and Spending (0.9%) as well as Core PCE (0.5% M/M, 4.7% Y/Y). Later we get Chicago PMI (55.0) and then Michigan Sentiment (51.1) with a lot of attention to be paid to the inflation expectations (1yr 5.2%, 5-10yr 2.8%). If the latter continue to slide, the Fed will feel a lot better, and you can bet that equity markets will respond. But beware if those numbers tick higher.

There are no scheduled Fed speakers until Tuesday, so we will watch the data and then how the narrative evolves. Right now, the dollar is on its heels, and I imagine that will continue until the data convinces us otherwise.

Good luck, good weekend and stay safe
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