SMBC Capital Markets, Inc.

fxPoetry

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Dropped His Mic

Said Jay, we'll not be premature
In halting the only true cure
For stubborn inflation
So no relaxation
Is coming, high rates we'll endure

Investors who had strong belief
That Powell would bring them relief
Are now feeling doomed
As what they assumed
Has led their positions to grief

ICYMI Chairman Powell was surprisingly, nay shockingly, forthright in his comments on Friday, when he described just how committed he and the Fed were to bringing inflation lower. He explained, [emphasis added everywhere] "*While higher interest rates, slower growth, and softer labor market conditions will bring down inflation,* ***they will also bring some pain to households and businesses****. These are the unfortunate costs of reducing inflation.* ***But a failure to restore price stability would mean far greater pain.***"

He also made clear, *"Restoring price stability will likely* ***require maintaining a restrictive policy stance for some time****.* ***The historical record cautions strongly against prematurely loosening policy***." He concluded with the following, "*We are taking* ***forceful and rapid steps*** *to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored.* ***We will keep at it until we are confident the job is done****."*

Unlike most symposia speeches, this was short and to the point, a mere 9 minutes, at which point the Chairman ~~dropped his mic~~ thanked the audience, stood up and walked out. And it seems as though market participants, both traders and investors, have begun to get the message. Risk asset prices fell sharply on Friday and are continuing on that trajectory this morning. The widely discussed Fed pivot, the point at which the heat from weaker markets or a weaker economy reaches the point where the Fed can no longer stand the pain and eases policy, seems ever further away. The implication of Powell's speech seems to be that not only will the Fed funds rate rise above 4.0%, but it will remain there for quite a while. It will be interesting to see the dot plot in September, as I would anticipate that the 2024 dots will be uniformly higher, and that the longer-term dots may be so as well.

The essence here is that the Fed needs financial conditions to continue to tighten in order to reduce inflationary pressures. For that to occur, one or several of the following things need to happen; equity markets decline, the dollar rises, short-term rates rise, long-term rates rise. Naturally, if all these things occur, conditions will tighten that much sooner. And since Powell spoke, all of these markets have followed the proper path. But financial conditions, as measured by the Goldman Sachs Financial Conditions Index (a widely followed version) remain well below their level from June and even further below their long-term average. In other words, despite recent market moves, in an objective look, financial conditions remain easy. It would not be surprising for them to need to achieve an objective level of tight, and for quite a while, for the Fed to be successful in their fight against inflation.

I would contend that while there may yet be a Fed 'put' in the stock market, the strike price has fallen much further out of the money, perhaps 2500 on the S&P 500, and even then, only if we get there before the end of 2022. Thus far, there has been no market capitulation, no dramatic decline in prices where investors just give up all hope. Rather, the current selloff, which began in early January, has been quite orderly. It is for this reason that I believe there is much more selling to come. Bear markets only end when all hope is lost, and nobody wants to even discuss owning stocks. Meme stocks will be dead, crypto will be dead and in all likelihood, Treasury yields will be high enough that people will be comfortable earning their 4% or 5% with no risk. We ain't there yet, but I am pretty sure we will get there before this is all over.

Ok, so how have things behaved overnight? Ugh!

Equity markets around the world have followed Friday's sharp US declines with very limited exception. The Nikkei (-2.65%) led Asia lower with the Hang Seng (-0.75%) softer although Shanghai (+0.15%) managed to eke out the only gains on the board. This is odd given the news that new, more restrictive lockdowns are being put in place outside Beijing and in the port of Tianjin, arguably not an economic positive, and the fact that the analyst consensus has once again lowered their forecasts for Chinese GDP growth in 2022, down to 3.5% now.

In Europe, there is blood all over the screens as the DAX (-1.4%) and CAC (-1.8%) lead the way with the FTSE 100 benefitting by being closed today for the Late August Bank Holiday. I imagine it will be able to catch up tomorrow. Meanwhile, there is no respite in the US with futures all pointing lower by between -0.75% and -1.0% at this hour.

The problem for investors is that bond markets are also universally lower this morning with Treasury yields (+6.9bps) firmly above 3.0% in the 10yr and trading at 3.45% in the 2yr, its highest level since November 2007. But all of Europe is seeing much higher yields (Bunds +11.7bps, OATs +10.7bps, BTPs +11.2bps, Gilts closed) as not only have FOMC members been vociferously hawkish, but so too have a number of ECB members who continue to call for "strong determination to bring inflation back to target quickly" (Schnabel) and the need for "significant" action (Rehn, Villeroy) let alone the true hawks how have set 50bps as a base and are willing to consider 75bps (Holzmann, Knot, Kazaks). Given the far more dire economic conditions in

Europe, it is an open question as to whether they will be able to enact such firm monetary discipline, but for now, there is a growing consensus it is necessary.

Oil prices (+0.6%) are edging higher and continue to trade within their recent range, although each day they remain here, they appear to have formed a bottom on the charts with the next move likely higher. NatGas (+1.4% in the US -19.5% in Europe) are showing some differences as Germany announced that they expect to complete filling their storage even with Russia's restriction of flow. It seems that the Germans have been able to replace nearly 75% of their Russian gas with other sources, so their prospects for a warmer winter have improved. We shall see. Not surprisingly, gold (-0.5%) continues to slump amid the rising rate scenario and copper (-3.35%) has also suffered on the idea that economic growth is going to decline.

Lastly, the dollar remains very well bid, as would be expected given the Fed's stance. JPY (-0.6%) is the G10 laggard as while Chairman Powell was screeching like a hawk, BOJ Governor Kuroda doubled down on his belief that there was absolutely no reason for the BOJ to tighten policy and they would maintain NIRP and YCC for now. Look for USDJPY to breach 140 before long. AUD (-0.5%) and GBP (-0.4%) are next in line here with the former suffering on weaker metals prices and growth prospects while the latter finds itself in the crosshairs of a growing energy crisis and no leadership. The pound has made a new low for the move here below 1.17. However, all of the hawkish ECB rhetoric has managed to give the euro a fillip and it is now higher by 0.2%, although remains below parity.

In the emerging markets, KRW (-1.4%) and THB (-1.2%) were the leading decliners on the pure risk-off sentiment that emanated from Jackson Hole. CNY (-0.7%) and TWD (-0.6%) also saw real weakness with the renminbi trading to its lowest point in two years and heading inexorably to 7.00 and beyond. Meanwhile, the last time the New Taiwan dollar was at these levels was during the initial stages of the covid crisis.

On the data front, there is a decent amount of new information this week, and we do get payrolls on Friday.

Today	Dallas Fed Manufacturing	-12.7
Tuesday	Case Shiller Home Prices	19.2%
	Consumer Confidence	97.7
	JOLTS Job Openings	10475K
Wednesday	ADP Employment	300K
	Chicago PMI	52.5
Thursday	Initial Claims	249K
	Continuing Claims	1450K
	Nonfarm Productivity	-4.5%
	Unit Labor Costs	10.7%
	ISM Manufacturing	52.0
Friday	Nonfarm Payrolls	300K
	Private Payrolls	300K
	Manufacturing Payrolls	20K
	Unemployment Rate	3.5%
	Average Hourly Earnings	0.4% (5.2% Y/Y)
	Average Weekly Hours	34.6
	Participation Rate	62.2%

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

	Factory Orders	0.2%

Source: Bloomberg

So, obviously there is plenty to see, most importantly Friday's payrolls data as that is a key marker for the Fed. As long as the jobs market appears robust, you can be confident that the Fed is going to keep hitting the brakes. As well, as though we haven't heard enough from Fed speakers recently, we have Brainard today then Barkin, Williams, Mester and Bostic later this week. I don't expect any change in the message.

As Chairman Powell explained on Friday, we will need to see more pain in asset markets and higher interest rates in the US, and that continues to point to dollar strength. I believe we are getting set for the next leg higher, so EURUSD at 0.95 and USDJPY at 145 are well within reach.

Good luck and stay safe
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