SMBC Capital Markets, Inc.

fxPoetry

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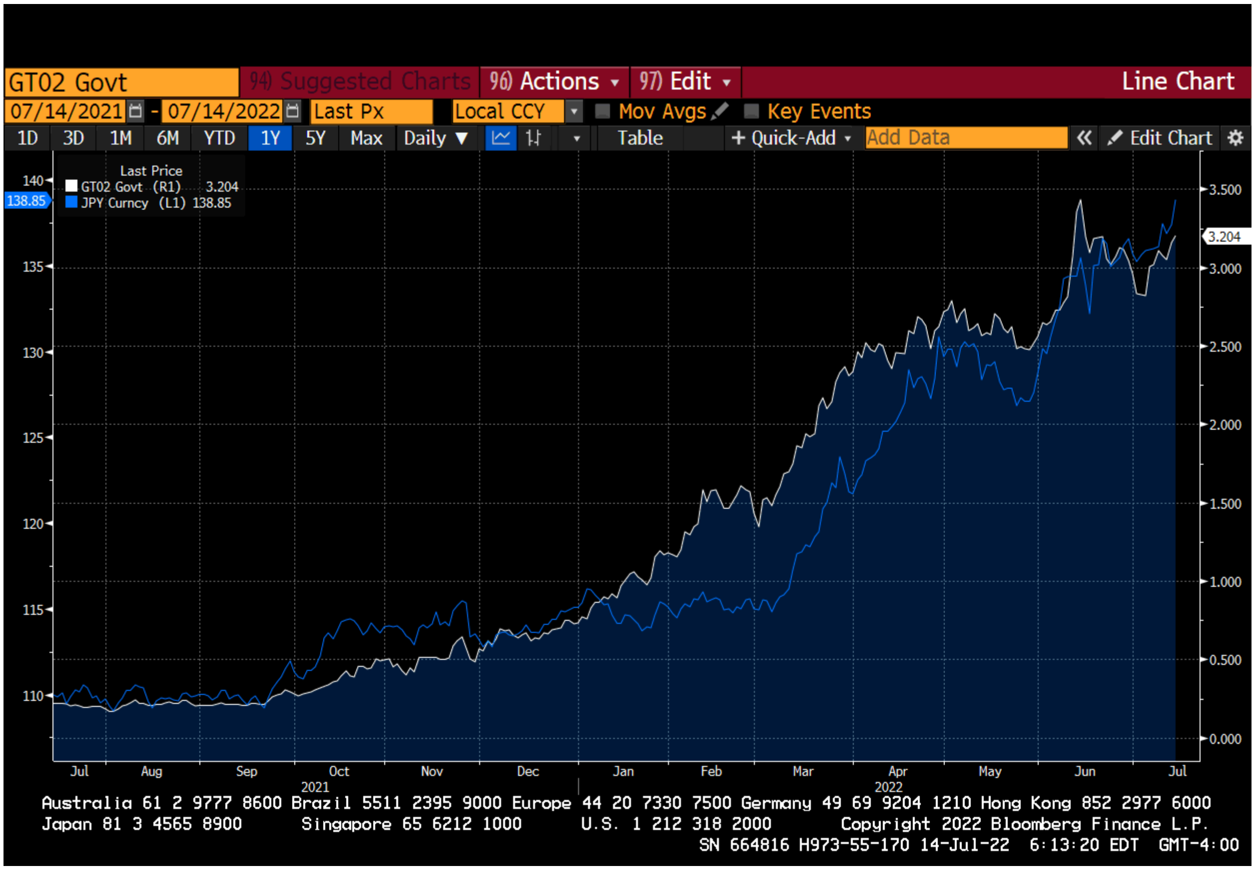
Mistakes Amplified

Kuroda fiddles
While the yen burns to the ground
Is he happy yet?

As I sat down this morning, I expected that the top story would be the continuation of yesterday's inflation narrative after the higher-than-expected CPI data and subsequent market reaction (remember, you heard it here first, before the print!) But I cannot ignore the fact that the yen has fallen more than 1% further this morning, trading above 139.00 and clearly setting up to test the psychological level of 140.00 sometime soon. Recall, last week, this was highlighted as the first potential level at which the BOJ might consider intervention in an effort to slow the yen's decline. Interestingly, the previous relationship between the 10-year Treasury (+3.3bps) and the yen (-1.1%) seems to have broken down. However, it has been replaced, for now, by the 2-year Treasury (+4.6bps) which continues to rise as the US Treasury curve inversion steepens further. (It is now at 23.5 basis points, its steepest inversion since June 2000.)



2Yr Treasury vs. USDJPY spot from Bloomberg

Investors are having a difficult time synchronizing their views across markets as the bond market is clearly pointing to a recession by early next year with interest rate futures markets in concurrence, but the equity market continuing to believe in higher earnings and a rosy outcome. Clearly, commodity investors see recession on the way, hence the dramatic declines in oil (-2.4%) and copper (-1.5%), and arguably the FX market sees the same thing as the dollar remains the purest haven asset around with everybody seeking to own it. The one thing that is clear is that the rest of 2022 and at least the first part of 2023 are likely to see a continuation in market volatility as the combination of central bank policy tightening alongside supply shortages in critical materials like food and energy wreak havoc on investors' psyches and portfolios.

Remember the time, long ago
When Powell said price hikes would slow
And Christine Lagarde
Relayed the canard
The best thing was their status quo?

It seems either both of them lied
Or else their mistakes amplified
The real situation
Of rising inflation
Which no longer can be denied

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Which takes us to yesterday's CPI report. By now we are all aware the headline number printed at 9.1% and the core printed at 5.9%, both higher than the median economist forecast, as well as the Fed's own forecasts. Of more concern was the breadth of the price rises where **more than 70% of the CPI subcategories are inflating faster than 5% and more than 20% are inflating faster than 10%** (hat tip to @inflation_guy). In other words, this is not due to used car prices or lumber, this is a widespread rise in the price level across virtually everything. Of course, you all knew this because unlike the PhD's at the Fed, you go out into the world every day and need to buy things like food and gas while still paying your rent or mortgage.

At any rate, as forecast by a certain poet, the market immediately began pricing a much greater probability of a 100 basis point rate hike in two weeks which was essentially confirmed by several unscheduled FOMC members saying things like, "*Everything is on the table*" according to Raphael Bostic of the Atlanta Fed and "*1 percentage point hike is in range of possibilities*" according to San Francisco's Mary Daly. As well, Cleveland's Loretta Mester explained she "*doesn't see any need for July rate rise **under** 75 basis points*." [emphasis added]. At this point, it seems pretty apparent that Fed funds are going to be raised a full percentage point on the 27th of this month.

So, does anything else matter now? As far as financial markets are concerned, the answer is no. Commodity markets are a bit different, as they remain beholden to supply and demand, and the perceptions of the future, but remember, while a recession may result in a short term reduction in demand, it is unlikely to be enough to offset the structural supply shortage in so many important commodities. Add in the weather (heat waves in Europe and much of the mid-west) and the uncertainty over President Putin's actions regarding NordStream 1, and this is a recipe for more volatility as well as higher prices…eventually. Oh yeah, one other thing has been confirmed and that is China has authorized the spending of $1.1 trillion on infrastructure for the rest of this year, which will almost certainly require significant energy and commodity utilization. In the medium and long-term, commodity prices remain undervalued.

Ok, so let's look at this morning's markets. In Asia, the Nikkei (+0.6%) managed to buck the trend and rise a bit while the Hang Seng (-0.2%) and Shanghai (-0.1%) both edged lower following yesterday's US declines. Europe, though, is having a tougher time (DAX -0.7%, CAC -0.8%, FTSE 100 -0.6%) with Italy's MIB (-2.2%) the real problem. It seems that the coalition government of Mario Draghi is about to break apart with no obvious successor and elevated concerns over "fragmentation." By the way, US futures are also pointing lower by about -1.0% at this hour.

Speaking of fragmentation, it is most evident in the bond market where Italian BTPs (+25.2bps) are collapsing vs. the German Bund (+9.1bps) taking that all-important spread to 215bps. Remember, Madame Lagarde is very keen to keep it under 200bps, and if we trade above 250bps, it will really test the ECB's resolve to tighten policy. This will be popcorn worthy. Meanwhile, OATs (+9.8bps) and Gilts (+4.8bps) are also selling off on rising inflation fears, but nowhere near the levels we are seeing in the PIGS and Italy especially.

As mentioned above, commodity prices are generally under pressure with NatGas (+1.5%) the exception as demand in the US continues to rise amid the heat wave and the need to produce electricity. Gold (-1.4%) has reversed yesterday's gains and remains under pressure from rising interest rates, at least near-term ones. As to foodstuffs, prices there are lower today as well and have come well off the post invasion highs which is arguably a very good thing.

Turning to the dollar, it has once again regained its crown as king for the day. While the yen (-1.3% now) is the worst G10 performer, CAD (-1.15%) is right behind, and that is after the BOC raised its base rate 100 basis points yesterday in a surprise move. But the best performer today, SEK (-0.3%) is falling and the euro (-0.4%), which did breech 1.0000 yesterday briefly before bouncing, is back just above it again. It is only a matter of time before parity becomes a key technical resistance level rather than a support.

As to the EMG space, ZAR (-1.4%) is the laggard today followed by MXN (-0.9%) and CZK (-0.65%). The rand is suffering as rolling blackouts extend throughout the nation, something to be feared here in the US if the temperature rises too high in certain sections, while the peso is feeling the heat from weaker commodity prices and the koruna is feeling the hangover from its 17.2% CPI print yesterday (and we thought we had problems!) I would be remiss if I didn't mention what has been happening in the US session to both CLP (-3.9% in past 3 sessions) and COP which had fallen as much as 5% earlier this week but has since recoupled the bulk of those losses.

On the data front we see Initial (exp 235K) and Continuing (1380K) Claims as well as PPI (10.7%, 8.2% ex food & energy) but given the CPI data has already been released, the potential impact here seems to be on equity markets. Remember, it is quite reasonable to consider the spread between CPI and PPI as a key pressure on corporate earnings. On the Fed front, Governor Waller is the only scheduled speaker, but recall, nobody was scheduled yesterday, and we had 3 FOMC members on the tape. Given Waller's underlying hawkishness, I expect he, too, will endorse the idea of 100bps.

Alas, the story has not changed. The Fed remains the most hawkish of the bunch and the dollar continues to benefit accordingly. Until the Fed story changes, while we may see short term trading adjustments, the dollar remains in a strong uptrend. Hedge and trade accordingly.

Good luck and stay safe
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