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B*tch-Slapped

Tomorrow, the CPI reading
May help show price pressure's receding
Or else it may show
That there's been no whoa
And prices will keep up their speeding

Chair Powell and friends will be rapt
As right now they're feeling quite trapped
Inflation is high
Recession is nigh
And daily they're getting b*tch-slapped

dol·drums

/ˈdōldrəmz,ˈdäldrəmz/

noun

1. a state or period of inactivity, stagnation, or depression.

It is hard to find a better word to describe yesterday's market than this as activity was lackluster virtually across the board. Prices traded either side of unchanged in the equity, bond and FX markets with even commodity markets generally benign. Arguably, this is because the investment community is anxiously awaiting tomorrow morning's CPI release as the next clue for the Fed's next steps. As of now, Fed funds futures markets are pricing in a 0.69% rate hike for September, so basically a 75% chance they will raise by 75bps. But, despite a constant refrain from the most dovish Fed members that they are "far from done yet," traders and investors are dismissing this as cheap rhetoric and still pricing in a pause by December and cuts starting next year. And who knows, perhaps the markets have sussed out the Fed's reaction function better than the Fed.

However, despite the fact that gasoline prices have fallen over the past 5 weeks, the evidence of prices stabilizing, let alone declining, in any other area is scant. And it is critically important to

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remember this as well, slowing inflation does not mean lower prices, it simply means that prices are rising at a slower pace. Until we get to outright deflation, the current price levels that you see every day are going to be with us forever. As well, if inflation slows to 6.0% by the end of the year, that is still 3x the Fed's target and unlikely to be acceptable regardless of the economic growth story at that time.

One other thing to keep in mind on the inflation front is that housing, which makes up about one-third of the CPI story, is designed to move slowly and tends to lag in its reporting. As such, it is very likely to continue to rise for the next several months in the CPI data regardless of what is happening on the ground. After all, when Case Shiller Home Prices were rising at 20% annually, that was not reflected in the CPI data, so if that survey starts to slip back, which seems highly likely, it will also take a long time to be reflected in the CPI. The point is, there is a lot of inflation already baked into tomorrow's CPI data that has almost nothing to do with price readings in the past month. In fact, other than energy, which accounts for just ~7.5% of the index, everything else takes far more time to enter the calculations.

This is why CPI (along with Unemployment) is seen as a seriously lagging indicator. This is also why the Fed is forever doomed to be behind the curve. The two indicators that they can point to when adjusting policy are both terribly backward looking. They are, by definition, fighting the last war at all times. Data dependence is another way of saying they are certain to respond too late to ongoing, and prospective, activity.

As of right now, according to Bloomberg, the median forecast has just edged up to 8.8% Y/Y with a fairly narrow range of 8.5%-9.0%. Now, even at the high end, this would mark a slight decline from June's reading, but would hardly seem like enough to get the Fed to change its tough rhetoric. In fact, I believe we would need to see a reading at 8.0% or lower to see anything like that. One other thing to remember is core CPI, which is forecast to print higher at 6.1% Y/Y. This dichotomy comes from the movement in gasoline but may well be more concerning to Powell and the Fed as it implies underlying price pressures remain quite strong. And they do. FWIW I anticipate that tomorrow's Fed speakers, Evans and Kashkari, will both be quite adamant that the Fed still has a lot of work to do and is not nearly done. The question is, will the markets believe them? I guess that depends on the number, with a high surprise likely to see the market price in more tightening while a soft number will likely see a massive rally in the 10yr-30yr part of the curve along with equities. I would expect the dollar to suffer then as well.

But that is all tomorrow's story. A recap of today is somewhat less interesting. After lackluster trading in the US yesterday, Asia was mixed overnight as the Nikkei (-0.9%) fell on some soft earnings news and the Hang Seng (-0.2%) and Shanghai (+0.3%) showed little interest overall. Europe has turned a bit lower on the day with the DAX (-0.9%) leading the way followed by the CAC (-0.4%) and the FTSE 100 (-0.1%). There has been precious little data of note to drive things here and there is nothing on the slate from Europe for the rest of the day. US futures, which had been marginally higher earlier in the session are now down about -0.2%.

Yields are higher both in the US (Treasuries +3.5bps) and Europe (Bunds+3.9bps, OATs +5.0bps, Gilts +2.6bps, BTPs +5.5bps) with that Bund-BTP spread still well over 200bps and of constant concern to the ECB. I read an analysis that showed net buying of BTPs was entirely by the ECB, with every other demographic (Italian investors, international investors, retail investors) shying away from the paper. Europe has a lot of problems. As well, the US curve continues to invert further with the 2yr-10yr spread now up to 44bps and climbing (sinking?) We have now taken out

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the lows seen in March 2000 and March 1989 with the next stop September 1981 at 85bps. The record low was 200bps in March 1980, but that seems somewhat of a stretch, at least for now. Perhaps if Powell really is the second coming of Volcker, we could get there!

Oil prices (+1.4%) are continuing their rebound from recent lows as it appears supply issues are outweighing the recession demand destruction story today. NatGas (+2.0%) is also rebounding with the continuation of the US heat wave likely driving up demand. Gold (+0.1%) continues to edge higher, with various explanations (inflation, war, risk aversion, lower real interest rates) although I'm not sure which to believe. But both copper (+0.2%) and aluminum (+1.5%) are on the upswing with copper beginning to look like it has put in a bottom technically and has room to run higher.

Finally, the dollar is modestly weaker overall with a mixed but dull picture in the G10 where NOK (+0.4%) is following oil higher and leading the pack while the euro (+0.25%) is the next best performer. AUD (-0.2%) is today's laggard, but that seems a trading reaction to yesterday's quite strong performance. In the emerging markets, THB (+1.1%) is the leader after the government downgraded the Covid stance to "needs monitoring" from "dangerous". But after that, the biggest gainer is ZAR (+0.3%) which is hardly enough to even consider. Granted, there are more EMG currencies with small gains than losses, but it is hard to make the case anything matters here.

Earlier the NFIB Small Business Optimism Index was released at 89.9, slightly better than expected, but still much lower than its long-term average, and even levels seen post-Covid initially. At 8:30 we see Nonfarm Productivity (exp -4.7%) and Unit Labor Costs (9.5%) data that generally has not direct market impact, but based on those estimates, data that points to stagflation in the US. There are no scheduled Fed speakers, so once again, we will be looking to equities and bonds for FX clues. If Treasury yields continue to edge higher, I expect the dollar will follow. But don't look for too much today as all eyes focus on tomorrow morning's CPI.

Good luck and stay safe
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