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fxPoetry

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The Red Pill

So, 50's the new 25
As central banks worldwide all strive
To tackle inflation
Whose excess duration
Shows no signs its due to nosedive

This leads to the question of, Will
The ECB take the Red Pill?
Or will they maintain
From Finland to Spain
Their policies highlight their skill

The Reserve Bank of India was the latest central bank to surprise markets and raise their overnight interest rate (the Repurchase Rate) by 0.50%, a bit more than expected, and take it up to 4.90%. The RBI is now the 38th central bank, of the 168 I can find, that has raised interest rates by at least 50 basis points in the past month. After all, none of us can forget Australia yesterday, and of course, the Fed raised the Fed funds rate by 0.50% in May and is slated to do so again next week and next month at the very least. The point is the world's policymakers have finally figured out that slow and steady may not be sufficient to address the results of ~~their multiple previous policy mistakes~~ the recent price pressures driven by energy shortages, food shortages, logistics snafus and EXCESS MONEY PRINTING (sorry for shouting).

This is important because tomorrow Madame Lagarde will lead her band of merry (wo)men to a decision and the world is anxiously awaiting the outcome. We already know that inflation in the Eurozone is flying with the latest print at 8.1%. We also know that, remarkably, the ECB continues to buy assets to this day, although it is widely believed that they will be ending this policy early next month ahead of their next policy meeting. And so, all eyes are on the indications of what type of interest rate adjustment the ECB is planning on taking come the July meeting. As it currently stands, the signals are they will be raising the deposit rate by 25bps as despite a small kettle of hawks, the bulk of the committee remains on the dovish side, including most importantly, Madame Lagarde herself. But consider, a 25bp rate hike in July will mean the Eurozone is maintaining negative nominal interest rates despite nearing double digit inflation. It strikes me there are some strong analogies between ECB policy and that of the Central Bank of Turkey. You remember them, they are cutting interest rates in the face of 73.5% inflation. While I grant the Turkish number is a bit larger, the fact remains that ECB policy is crazy loose, even if they raise rates back to 0.0%!

Of course, Lagarde's main concern is what happens to the spread between peripheral sovereign bond yields and German bunds. Right now, 10-year Italian BTPs yield 200 basis points more than 10-year German bunds. That is already on the edge of a problem and the ECB is still supporting the peripheral markets. When they stop doing so by ending QE, there is every chance that those spreads widen further. At some point, probably around 300bps for BTPs, the pain will likely become too great for the ECB (and Italy and the rest of the PIGS) to tolerate and there will need to be some adjustments. The problem is, the only thing they can do to address that is buy more peripheral bonds which sounds an awful lot like QE, something they ostensibly are trying to end. I don't envy Madame Lagarde and her troupe the problems they have to address, but of course since those problems are entirely of their own making, I don't pity them either. Tomorrow's press conference should be educational.

In the meantime, let's scan markets this morning. After a rally in the US afternoon, equities in Asia followed along with gains across the board (Nikkei +1.0%, Hang Seng +2.25%, Shanghai +0.7%). Europe, however, is on a different page with losses across the board (DAX -0.5%, CAC -0.7%, FTSE 100 -0.4%) as a combination of growing concerns over an ECB policy mistake and overall slowing growth in the future have dominated the news that Eurozone GDP was actually stronger than expected in Q1, rising 0.6% on the quarter and 5.4% Y/Y. But that is backward looking and markets look the other way. US futures are also pointing lower, but only about -0.3% in the main indices.

Bond markets are under pressure this morning despite the equity weakness with yields higher across the board. Treasuries (+3.1bps) are actually holding up better than Bunds (+4.7bps), OATs (+5.2bps) and BTPs (+7.0bps), while Gilts (+2.9bps) are trading in a similar fashion to the US. My take on recent price action in the bond market is that investors have completely given up on the idea that the central banks are going to be able to manage inflation in any effective manner for quite some time and so yields need to rise much more to reflect the new realities. The only outlier here is Japan, where the BOJ continues to buy an unlimited amount of JGBs in order to cap yields at 0.25% in the 10-year. Alas, one of the problems with that is its impact on the JGB market, where last night exactly ¥0 10-year JGBs traded. Perhaps describing it as a market is the mistake.

A quick look at commodities shows that oil (+0.95%) continues its recent overall trend higher and WTI is back above $120/bbl right now. I fear this has much further to go. NatGas (0.0%) is unchanged in the US but continues to decline in Europe (-1.1%) although still has miles to go to achieve parity with US pricing. Gold (-0.2%) continues to hang around $1850 although clearly there are growing concerns over the global growth situation as copper (-0.9%) continues its recent weak price action. As it happens, the grains are all higher this morning but remain some 10% below their recent highs.

Finally, looking at the dollar shows more strength than weakness led by JPY (-1.05%) as the yen trades to new lows for the move. At this point, given the ~~stubbornness~~ insistence by the BOJ that they are not going to change their policies, and given the fact that the Fed certainly appears set to continue to tighten policy here, there is no reason to believe that this move is anywhere near an end. Until US yields convincingly reverse lower, USDJPY has no top. 140? 150? Higher? It's all just a matter of time. As to the rest of the G10, NZD (-0.5%) is the next worst performer and then AUD (-0.4%) as risk concerns are at the fore. In the emerging markets, TRY (-2.35%) is seeking to take out its previous lows having fallen to within 7% of that level over the past month and also showing no sign of stopping. But other than that, modest risk-off with small weakness is a better description of the space.

There is neither data nor commentary from Fed speakers today so the FX market will continue to take its cues from the broader risk narrative and stocks. Except for USDJPY, which remains entirely beholden to 10-year Treasuries. Right now, the trend remains for the dollar to continue higher.

Good luck and stay safe
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