SMBC Capital Markets, Inc.

fxPoetry

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A Great Sense of Dread

The dominant color is red
On screens as a great sense of dread
Is filling the hearts
Of traders whose charts
Explain that investors have fled

The problem's recession is nigh
Though policymakers all try
To tell us we're wrong
And growth is still strong
As data they seek to deny

The situation in markets is starting to turn quite unpleasant for most investors as both equity and bond markets suffer under the current economic situation. Continued high prices along with rapidly slowing growth and energy shortages, a toxic trio if ever there was one, are forcing investors to seek the safety of cash. Arguably, despite inflation's slow reduction in the purchasing power of cash, at least the notional amount doesn't decline. These days, whether you invest in stocks or bonds, as prices of both fall, the pain increases every day. Ergo, cash doesn't seem like such a bad idea after all.

It's not as though we needed more catalysts for markets to sell off, but we got a bunch overnight anyway. Whether looking at PMI data, where Australia continued to trend lower at a still reasonable 53.8, but China's Caixin PMI fell to 49.5 and South Korea's fell to 47.6 (in fairness, Japan held up well at 51.5), or we consider that South Korea's trade deficit of $9.47B in August was the largest in its history, it is no surprise that risk was offloaded. So, the Nikkei (-1.5%), Hang Seng (-1.8%), Shanghai (-0.5%) and KOSPI (-2.3%) all fell sharply.

Moving to Europe, the PMI data made for similarly dismal reading with Italy (48.0), Germany (49.1) and the UK (47.3) all remaining firmly in recessionary territory, although France (50.6) managed to surprise on the upside. However, the Eurozone as a whole (49.6) slipped further as well which will add further pressure on the ECB as record inflation is combined with rapidly slowing growth. The contingent of hawks at the ECB continues to make their case for 75bps next week, but we are hearing pushback from the doves who want a more measured pace of tightening. Of course, if I was the Greek or Italian central bank chief, I would want negative rates forever, so this is no surprise. While several investment banks are now forecasting a 75bp rate hike by the ECB, and the OIS market is pricing a 72% chance of that hike, I am not convinced that Madame Lagarde will be so aggressive.

Equity markets in Europe, though, are having another rough go of it, with the DAX (-1.4%), CAC (-1.5%) and FTSE 100 (-1.5%) all under continued pressure. YTD, these indices are down by 20.3%, 15.7% and 2.8% respectively, which means that the UK has been the best performer of the lot. Of course, part of that is because it has lagged any up move previously. And as we await the ISM data here this morning (exp 51.9), US futures are all in the red as well, between -0.5% and -0.9% as I type at 7:00am.

All this negativity begs the question, what is needed to turn things around? Well, if anyone was waiting for the Fed to come to the rescue, I expect they will be waiting longer than Vladimir and Estragon did for Godot. This was reinforced yesterday by Loretta Mester who explained she favored raising rates above 4% in early 2023 and that they need to stay there for a while. "*This is going to be a long fight*," she told us, and the "*Fed will be resolute in bringing inflation down to 2%*." In other words, there was no indication that a pivot is on anyone's mind.

Recall what Chairman Powell told us last Friday, that the lessons of the 1970's great inflation was that the Fed cannot declare victory too soon. The Fed clearly remains committed to slaying the inflationary dragon, although the pain it causes may rise considerably. At this point, I would not bet against continued aggressive rate increases and so I believe risk assets will remain under severe pressure while the dollar remains bid.

In the meantime, adding to the world's economic issues, China locked down Chengdu, a city of 21 million in the Western part of the country as 157 new Covid cases were reported. While the rest of the world does not understand the need for these draconian measures, that has not stopped President Xi from continuing on this path. Apparently, he is willing to sacrifice his economy in the short-term (and perhaps longer) in order to eradicate the uneradicatable. This action will do further harm to already fragile supply chains and likely eventually show up in higher prices as well.

I am sorry to be the bearer of such a long list of bad news, but unfortunately, the situation around the world is such that a long history of bad policy choices by western leaders has achieved a series of unfortunate events. (And frankly, I doubt Lemony Snickett could have come up with this list as truth truly is stranger than fiction.)

One of my favorite reads is "Doomberg" a substack that addresses current issues, many energy related, through a lens of logic and physics, with some Austrian economics attached. @DoombergT is the Twitter handle and I highly recommend following him. I mention this because in his latest piece he coined the term AntiLogic™ as a description of the process by which politicians arrive at decisions. Whatever the best choice, you can be sure they will do the opposite. Europe, especially, but the world as a whole, is currently suffering the consequences of energy policy decisions past and there are no easy ways out. While oil prices have been falling sharply for the past several days on fears of a widespread global recession, and are down another -1.85% this morning, I'm pretty sure crashing the economy was not the first choice for political leaders to drive oil prices lower. However, that appears to be their current strategy, or at least result. Worse is yet to come, I fear.

As to the rest of the markets, bonds are falling everywhere as yields continue to climb. Treasuries (+0.6bps) are the winner today as European government bonds (Bunds +3.9bps, OATs +4.5bps, Gilts +4.7bps, BTPs +6.7bps) all sell off harder despite weaker equities. Even JGBs (+1.5bps) have been selling off lately, although yields remain capped and sit at 0.234%. Meanwhile, 2yr Treasuries traded through 3.5% yesterday and are hovering right there at this time. Of course, if the Fed is really going to 4%, then these yields have further to rise as well.

Finally, the dollar remains on top of the world, rising against all its G10 counterparts as well as virtually all EMG currencies. NOK (-1.0%) continues to get dragged down by oil while SEK (-0.65%) is next worst after a much worse than expected PMI reading of 50.6, still above the boom-bust line, but the lowest level since Covid. The pound (-0.45%) is also under real pressure with the rest of the bloc sliding somewhat less. It should be no surprise that KRW (-1.2%) was the big loser in the EMG bloc after that abysmal trade and PMI data, and then THB (-0.55%) followed after a worse than expected current account deficit was reported. Here, too, the rest of the space is weaker on pure dollar strength.

On the data front, Initial (exp 248K) and Continuing (1438K) Claims lead the day alongside Nonfarm Productivity (-4.3%) and Unit Labor Costs (10.5%). Truthfully, you could not find a better description of the US economy than those latter two numbers. Of course, at 10:00 we get the ISM data, which while still above 50 has been trending lower pretty steadily since March 2021. We also hear, again, from Atlanta Fed President Raphael Bostic, but his views are already widely known and in line with Mester and virtually all the others.

I don't know what will change any attitudes, but there is certainly nothing compelling that indicates the Fed is going to slow down its inflation fight and so risk assets ought to remain under pressure. We would have to see a negative NFP print tomorrow and Unemployment jump to 4% or more to even get a reaction I think. As such, I think this trend is set to continue, a stronger dollar and weaker risk assets. Hedge accordingly.

Good luck and stay safe
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