SMBC Capital Markets, Inc.

fxPoetry

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Rare and Exceptional

Said Yellen, in general our view
Is G-7 nations ought to
Leave markets alone
Though many bemoan
The dollar's strength, we won't subdue

"Only in rare and exceptional circumstances is intervention warranted and we did not discuss intervention."

So said Treasury Secretary Yellen last night after meeting with Japanese FinMin Shinichi Suzuki in Tokyo in a meeting designed to discuss a range of topics including the impact of the war in Ukraine on financial markets and the global economy. Yet despite her denial of intervention discussion, the joint statement released after the meeting explained the US and Japan will "…**consult closely on exchange markets and cooperate as appropriate on currency issues**." [emphasis added] Now, I don't know about you, but it certainly seems, based on that statement, that intervention would have very likely been part of the conversation. After all, the yen has fallen a solid 16% so far in 2022 and is now trading at levels not seen since 1998.

Remember the words of a former German Chancellor and widely renowned politician, Otto von Bismarck, "Never believe anything until it has been officially denied. Then you will know it is true." Over time, this has proven to be sage advice and I expect that is the case here as well. It beggars' belief that Yellen and Suzuki would discuss the FX markets and pledge cooperation without having even discussed intervention. This is not to say that intervention is coming soon, just that it is almost certainly on the radar of both of these central banks. The stress on the Japanese people due to the rapid rise in energy prices is very real, and although headline inflation in Japan is only at 2.5%, remember that is the highest level seen since 2014, and if you look through that episode, which was a result of the government raising the VAT by 3% and so lasted only 1 year, CPI has not been at these levels since the early 1990's. This is not a nation that is psychologically prepared for high inflation. While the yen (+0.35%) today is modestly firmer, it seems a test of 140 remains increasingly likely, although based on the Yellen comments, I wouldn't be surprised to see intervention at that time.

There once was a nation that fought
Inflation and all that it wrought
But it joined a bloc
Of countries whose stock
In trade was, weak money they sought

The inflation/recession argument continues apace amongst market participants with no firm conclusion yet reached. (This author falls into the stagflation camp, with recession upcoming but it having only a minimal impact on prices.) Thus, every piece of data is parsed with an eye toward helping come to agreement on the issue. This morning we saw the German ZEW data which was, in a word, horrific. Survey expectations fell to -53.8, far below the forecast of -45 and the second lowest reading of all time in the series dating back to 1991. This is clearly not a harbinger of future growth, but rather of an impending recession. Then, moments ago, the NFIB Small Business Optimism Index was released here in the US at a much weaker than expected 89.5. This number has been falling uninterrupted for the past 13 months and steadily since September 2018. The state of small business in the US is clearly under pressure and with it, the state of the economy. Again, a harbinger of recession if ever there was one.

Adding to recession fears are increasing Covid cases in China and the increasing potential for another wave of severe lockdowns as well as the situation in Europe with the annual closing of the NordStream 1 pipeline for maintenance, and the uncertainty as to whether or not it will be reopened by Russian President Putin. If it is not reopened, early estimates are it will reduce German gas supplies by 35%, driving prices for NatGas much higher in Europe and ensuring a recession. As an example, NatGas prices today are higher by 0.75% in the US (after a 7% rally yesterday), by 4.25% in Europe and by 21.5% in the UK! As a comparison, NatGas in Europe is pricing at the equivalent of $50/MMBtu. vs. $6.50 in the US. In case you were wondering what impact this was having on Europe, let me point out that in May, Germany's trade balance fell to a deficit for the first time since June 1991. Again, the future of the euro remains quite cloudy in the current situation. Weak growth, lack of energy, rising prices and policy stagnation are not the recipe for optimism. The euro (-0.25%) has thus far held up at just above parity, but parity is just a number, it is not a fundamental. The fundamentals point lower from here for the single currency.

And with that, let's see how the market feels this morning, which can be summed up as; lousy. After yesterday's weak US equity performance, we saw that same attitude in Asia (Nikkei -1.8%, Hang Seng -1.3%, Shanghai -1.0%) and Europe (DAX -0.7%, CAC -0.2%, FTSE 100 -0.35%) albeit not as badly there. US futures are all pointing lower as well, -0.5% or so.

Bond markets are behaving as the havens of yore with yields much lower across the board. Treasuries (-7.9bps) are lagging relative to Europe (Bunds -13.2bps, OATs -13.7bps, Gilts -15.3bps) as fears over the situation in Europe grow rapidly. Interestingly, the futures markets are still pricing in a number of rate hikes in the Eurozone, with the target rate expected to climb to 1.0% by next spring. I would take the under there.

While NatGas is flying, oil (-4.75%) is falling sharply on recession worries. Meanwhile although gold is unchanged on the day, copper (-2.1%) continues to suffer on those same recession fears. In fact, most of the industrial metals are softer although aluminum (+0.2%) has somehow managed to eke out a gain.

Finally, the dollar, aside from against the yen this morning, is higher against all its other counterparts. In the G10, NOK (-0.4%) is the worst performer, following oil down, but the pound (-0.4%) and CAD (-0.3%) are also soft with the former seeing weakness due to the ongoing political uncertainty while the Loonie is clearly under pressure alongside commodity prices. In the EMG bloc, HUF (-1.0%) is the weakest of the bunch followed by MXN (-0.7%) and PHP (-0.7%). But there are no gainers here. The HUF story, if it needs anything beyond the dollar's strength, is market participants are waiting the central bank's latest decision after a surprise 200bp rate hike last time. Clearly fear is in the air there. In Mexico, meanwhile, weaker oil and commodity prices are undermining the currency while the Philippine version of the peso suffered on a record trade deficit in April (just released last night). But every currency in this bloc has fallen vs. the dollar today.

On the data front, we already saw the NFIB number and there is nothing left on the calendar. Meanwhile, we are scheduled to hear from Richmond Fed President Barkin at 12:30 in a recession discussion (I'll bet he doesn't see one coming!) although we are likely to hear from other Fed members in impromptu interviews based on their recent activity. Just yesterday, we heard from Bostic and Bullard despite neither being at an official event, and both reiterated that 75bps are on the way later this month and rates need to be higher. Also, neither was concerned over a recession.

I wish there was something new here, but the reality is that right now, things continue to point to a stronger dollar. The Fed continues to sound the most hawkish and data elsewhere in the world is even worse than in the US. Tomorrow's CPI data will be interesting and if we do see a 9 handle on the headline number, I expect to start to hear about 100bps as a possibility for the end of the month. Hedgers, take advantage of any dollar pullback as this trend can definitely go on much longer.

Good luck and stay safe
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