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fxPoetry

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# Can't Stand the Pain

Confusion continues to reign
With equities feeling the strain
As markets await
Chair Powell's update
Some bulls find they can't stand the pain

The big story this week is Friday's speech by Chairman Powell with investors and analysts all waiting for clues as to just how tough the Fed is going to be on inflation going forward. While the market continues to price for a pivot by the Fed next year, it has backed away from the most extreme levels seen several weeks ago. In fact, this morning the probability of a 75bp rate hike in September has risen back to 66%, up from the 50% level seen last week at this time. Recall that last week we had yet another wave of Fed speakers coming out and explaining that the job was not nearly done and that moving interest rates into restrictive territory, and keeping them there for a while, was still on the cards.

My observation has been that the FX market was the only one which was taking the Fed to heart, although Friday's equity price action, as well as what we are seeing today, is an indication that the message is starting to get through. For instance, overnight in Asia the only green on the screen was in Shanghai (+0.6%) after banks in China lowered their prime lending rates in both the 1yr (-5bps) and 5yr (-15bps) periods. Clearly, the PBOC is growing increasingly concerned about the slowly imploding property sector in the economy, and rightly so. Given its size and importance to China's two decades of explosive growth, if it collapses in on itself, that bodes quite ill for China's future economic output. But elsewhere in Asia (Nikkei –0.5%, Hang Seng -0.6%) the news was less positive.

Europe, meanwhile, has seen a more significant decline (DAX -1.5%, CAC -1.2%, FTSE 100 -0.3%) as concerns continue to grow regarding the energy sector, specifically NatGas (+4.7% in the US, +18.9% in Europe, +21.5% in the UK) which seems likely to devastate the Eurozone (and UK) economy going forward. As an example, this morning's NatGas price in Europe is now $83.75/MMBtu, nearly 9x the US price at $9.60/MMBtu. Winter in Europe will not be pleasant this year. As an aside, a Citibank economist just published a note forecasting CPI in the UK to reach

18.6% by January. And you thought we had problems!! Lastly in the equity world, US futures are all lower by at least -1.0% at this hour, after a pretty weak Friday session.

What if twas a paradigm shift
In Germany, ending their thrift
As nobody's left
With mem'ries of theft
From 'flation or Havenstein's gift

Given the importance of Powell's speech on Friday and the likelihood that there will be a limited amount of really important news between now and then, I thought I would take a look at Europe, as a podcast I listened to this weekend has made me reconsider the underlying framework of my views on the Eurozone.

Briefly, when formed, the Eurozone was designed with the idea that as a group with a single currency, Europe would be able to increase its sway on global events given the combined size of the economies there. However, in order to gain acceptance by Germany, they had to promise that the ECB, which would essentially be replacing the Bundesbank, would need to hold to the idea that the only good currency is a strong currency, and that tighter monetary policy was always the side on which to err. LOL. And the Germans believed them!

The first indication that things would not be heading in that direction was the choice of leadership, where first Dutch central bank President Wim Duisenberg, and then Banque de France Governor Jean-Claude Trichet were named to split the initial 8-year term. While the Dutch were believed to share the same views as Germany regarding monetary policy, the French were clearly not. Things took a decided turn for the worse, at least from Germany's perspective, when Mario Draghi, erstwhile Governor of the Bank of Italy, was named to replace Trichet. At this point, there can be no doubt that ECB monetary policy was going to diverge with the principles of the Bundesbank. Of course, all pretenses were removed when Madame Lagarde, a politician with exactly zero central banking experience, was named as Draghi's replacement.

It seems the question is, why would Germany allow this to occur? And here is where this weekend was so enlightening. At least to me, although I don't believe I am the only one with this thought process, Germany was the very essence of sound monetary policy as the memories of the Weimar hyperinflation in the early 1920's was indelibly imprinted on every German's DNA. The analog to this was the fear of deflation/depression in the US given the 1930's events here in the States. But…nobody is left who lived through the hyperinflation, and the reality is that the children of those people have either passed or are too insignificant a force to be of concern. So, the lived experience of virtually every German today has nothing to do with hyperinflation, it is not a concern, it is but another chapter in their history books. As such, if the Germans are not hyper afraid of hyperinflation then there will be very little pushback against an ECB that maintains much easier monetary policy than might otherwise have been the case under a Bundesbank led world.

This has important ramifications, especially in the FX markets, because the idea that there is truly a hawkish wing of the ECB may well be a vast overstatement of the current reality. As such, with Europe barreling headlong into a recession, and one I fear could be quite deep, it seems to me the odds of the ECB aggressively tightening monetary policy to fight an energy led inflation are pretty low. And that means that the euro (-0.25%) has much further to fall. This morning the single currency is pushing parity again, but I have a feeling that the combination of the Fed continuing to hike rates through at least Q1 of next year (in my view) and a lax ECB as described above, means that a decline in the euro to well below 0.90 and possibly to new historic lows below 0.82 must become part of the thought process.

Ok, let's quickly touch on the rest of the markets. Bonds, despite the very clear risk-off tone in equity markets, are not seeing much demand with Treasuries unchanged, and European sovereigns all softer (Bunds +0.9bps, OATs +1.2bps, Gilts +3.7bps, BTPs +2.8bps). Asian markets, too, saw bond sellers. It appears that inflation fears are currently outweighing equity fears, although there is ample room for that to change.

The rest of the commodity space has seen oil with tiny losses (-0.1%), while gold (-0.7%) continues to be pressured by the strong dollar. As well, copper (-1.2%) and aluminum (-0.25%) are also under pressure with fears of recession growing.

As to the dollar, aside from the euro, the pound (-0.3%) is weak as is the SEK (-0.6%), which seems to be demonstrating its higher beta to risk. However, AUD (+0.45%) is bucking the trend, as traders are betting that Chinese rate cuts will help stimulate the Chinese economy more than previously expected. However, in the EMG space, every currency is weaker with HUF (-1.5%) the worst performer as investors are growing concerned that the NatGas price rises are going to have a particularly negative impact on Hungary, with the rest of the space showing some sharp declines (THB -1.1%, KRW -1.0%) but all based on the same story of risk-off.

There is some data ahead of Jackson Hole as follows:

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| Today | Chicago Fed National Index | -0.25 |
| Tuesday | Manufacturing PMI | 51.9 |
| | Services PMI | 50.0 |
| | New Home Sales | 575K |
| Wednesday | Durable Goods | 0.8% |
| | -ex transport | 0.1% |
| Thursday | Initial Claims | 252K |
| | Continuing Claims | 1443K |
| | Q2 GDP | -0.9% |
| Friday | Personal Income | 0.6% |
| | Personal Spending | 0.4% |
| | PCE | 0.0% (6.4% Y/Y) |
| | Core PCE | 0.3% (4.7% Y/Y) |
| | Michigan Sentiment | 55.5 |
| | **Powell's Speech** | |

Source: Bloomberg

Arguably, other than Powell's speech at 10:00 on Friday morning, the PCE data will be the most important thing to note. Especially after the CPI data printed softer than expected, a soft print here will require a great deal of hawkishness for Powell to keep things moving in the Fed's preferred direction of tighter financial conditions. However, until we get there, I expect that risk will continue to be jettisoned as positions are squared ahead of Friday.

Good luck and stay safe
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