SMBC Capital Markets, Inc.

fxPoetry

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Market Perdition

Four score and a dozen of years
It's been since investors' worst fears
Have come to fruition
In market perdition
Resulting in so many tears

So, what to expect in H2?
More pain? Or will Powell come through?
With prices still rising
It won't be surprising
If this is Chair Jay's Waterloo

First, a bit of news for any who might be interested; I was interviewed on a podcast called "Market Champions" which is due to be released on Sunday July 3rd. It was certainly fun for me, and I hope you enjoy it if you listen.

Now, on to less happy tidings with respect to the ongoing destruction of prices across almost all markets. Notice I didn't say value was being destroyed, as value has a very different connotation. Regardless of the share price of a company (assuming it's profitable), it still creates economic value. However, the price investors are willing to pay for that value definitely varies over time. At any rate, as has widely been reported, the S&P 500's first half performance was its worst since 1970, predating even the Arab oil embargoes, but not predating inflation's rise during the 1970's. I believe that something on the order of $8 trillion has been removed from the valuation of the S&P 500 since the beginning of the year. As we begin the second half of 2022, the question on everyone's lips is, what's coming next?

Well, if the Atlanta Fed's GDPNow is accurate, the fact that it just estimated a Q2 GDP decline of -1.0% at an annualized rate does not bode well for things. In the US, at least Chair Powell can look at the Core PCE measure released yesterday at 4.7%, a tick lower than expected, and try to make the case that his heretofore "aggressiveness" has been rewarded. Madame Lagarde, on the other hand, has no such respite when looking at today's Eurozone CPI release which printed at 8.6%, a tick higher than forecasts. Italy, meanwhile, saw CPI jump to 8.5%, by far its highest ever print since the inception of the euro. At this point, there is no indication that things are going to get better anytime soon on the continent.

A couple of other things to highlight include the balance sheets of the Fed and ECB. In the case of the former, you may recall that June was going to be the first month of QT with assets rolling off and a cap of $47.5 billion initially before finally climbing to $95 billion come September. Well, the figures are in, and the balance sheet has declined…$1.497 billion during the month of June. Certainly, they were not in danger of exceeding the cap! At this point, we have no idea how QT is going to impact markets because they haven't really started it. Maybe in July we will see some shrinkage. And look at equity market performance without QT. It seems unlikely QT is going to help the situation.

Meanwhile, Madame Lagarde announced the anti-fragmentaion plan which, as I have explained, is essentially the ECB will buy the bonds of the PIGS and sell Bunds and OATs (and Dutch bonds). Now, in fairness, they are not actually going to sell Bunds, they are simply going to take the proceeds of the Bunds et al that mature and reinvest them in BTPs, BONOs, GGBs and PGBs. They have come up with a 'new' framework splitting the Eurozone into three groups: Donors, Neutral and Recipients. The Donors (Germany, France and the Netherlands) are going to be donating to the Recipients (the PIGS) in order to prevent the euro from blowing to pieces. However, I have to wonder how the German populace is going to respond to the concept that they are donating their money to the Italians and Greeks. I have a feeling we have not heard the last of this.

At any rate, amid signs of recession in the US and Europe, one cannot be surprised that equity markets remain under pressure overall. At the same time, those recession fears are starting to help bond markets recover and commodity markets are taking it on the chin, well except for oil markets which have a life of their own.

As we start H2, risk remains out of favor overall as Asia (Nikkei -1.7%, Hang Seng -0.6%, Shanghai -0.3%) all slipped and Europe, which started the session a bit higher has now fallen back to basically flat on the day. US futures are all slightly softer, -0.25% at this hour (7:00 EDT) after yesterday's continued sell-off. I wonder what happened to all that equity buying that was going to be needed to rebalance portfolios. Apparently, it was not nearly enough to stop this trend. And my real concern is that this market decline has been very orderly with no sense of capitulation yet. My (too) long experience tells me that we are nowhere near the bottom yet and until we see some limit down sessions, we won't be.

Bonds, though, are behaving far better lately with 10-year Treasury yields (-6.1bps) having traded back below 3.0% this morning, a key technical pivot point. It seems pretty apparent that bond investors are preparing for much weaker US growth. In Europe, meanwhile, the rally is less robust, but yields are lower across the board. Bunds (-1.0bps), OATs (-1.1bps) and Gilts (-3.8bps) are all continuing their recent slow grind higher in price and Italian BTPs (-4.9bps) are definitely benefitting from the new anti-frag framework with the spread to Bunds down to 189bps. Even JGBs (-1.1bps) are backing away from the BOJs YCC cap with yields there down to 0.213%.

In the commodity space, supply problems for oil continue to haunt markets with WTI (+2.0%) this morning quickly rebounding from yesterday's recession concern induced selloff and NatGas (+5.35%) demonstrating why it is the most brutal of all commodities to trade, with volatility off the charts. Metals, though, are all-in on the recession story with gold (-0.9%) suffering but not nearly as badly as copper (-3.6%) and aluminum (-2.1%). Food prices, though off their spring highs, remain well above levels seen over the past decade and concerns over food shortages throughout the developing markets continue to be very real.

Finally, the dollar is closing the week on a strong note, rallying against all but one of its G10 counterparts and almost every EMG currency as well. JPY (+0.4%) is the outlier on the high side, as it continues to grind ever so slightly higher after touching 137 earlier this week. As US rates soften, it makes perfect sense that USDJPY does as well. But for the rest of the bloc, AUD (-1.55%) and NZD (-1.2%) are leading the way lower amid the commodity price rout. But the pound (-1.1%) is suffering on weak economic data and even NOK (-0.7%) cannot find any love despite oil's sharp rebound. The single currency (-0.3%) is slowly sliding lower although its prospects remain dire if the Fed actually does continue to tighten.

In the emerging markets, HUF (-1.1%), THB (-0.8%) and PLN (-0.7%) are the laggards this morning. In Budapest, the central bank is adjusting bank capital requirements higher with potential negative consequences for housing prices there and investors are concerned. As to the baht, it was a victim of the broad risk-off sentiment along with most Asian currencies, while the zloty reacted poorly to the 15.6% CPI print this morning, the highest since 1996.

This morning's data consists of ISM Manufacturing (exp 54.5) and Prices Paid (80.0) as well as Construction Spending (0.4%). With the GDPNow number turning negative and recession talk on many lips, the ISM number will be closely watched, especially in the wake of a full month of negative prints from regional Fed manufacturing surveys. Mercifully, the Fed seems to be taking a long weekend with no speakers scheduled.

It remains difficult to be optimistic about markets overall and combining that risk-off sentiment with the Fed's still hawkish rhetoric leads to the idea that the dollar has not reached the top yet. If we see US yields falling more sharply, I expect that will be sufficient for at least a pause, but if rates continue to grind higher, so will the dollar.

Good luck, good weekend and stay safe
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