SMBC Capital Markets, Inc.

fxPoetry

September 2, 2022

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The Fed Shall Not Stray

All eyes are, today, on the tape
For data that gives the landscape
Of jobs in the nation
And whether inflation
Is starting to take a new shape

But let's not forget what Chair Jay
Explained when he spoke last Friday
No pivot is pending
With prices ascending
From this path the Fed shall not stray

Welcome to Payrolls Day. With the Labor Day holiday quickly approaching, and so many trading desks on both the buy and sell sides already thinly staffed from summer vacations, I expect that by 10:00 this morning things will have settled down regardless of the data released. So, let's take a quick look at what is currently expected according to Bloomberg surveys:

Nonfarm Payrolls	298K
Private Payrolls	300K
Manufacturing Payrolls	15K
Unemployment Rate	3.5%
Average Hourly Earnings	0.4% (5.3% Y/Y)
Average Weekly Hours	34.6
Participation Rate	62.2%
Factory Orders	0.2%

The other employment indicators we have seen for August were mixed as the newly revamped ADP Employment report showed only 132K new jobs in August, but we saw a drop in Initial Claims to 232K, its lowest level since late June, and the ISM Employment gauge rose to 54.2, well above expectations and its highest in six months. The interesting thing about the latter is it is truly a

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forward-looking indicator, so potentially a tell for the future. Remember, too, the JOLTS Job Opening report showed more than 11.2 million job openings, nearly a million more than expected. Of course, last month we were treated to a huge positive surprise in the NFP report as well, so there is ample evidence on both sides of the argument regarding the shape of the US labor market.

The focus on this data is a natural byproduct of the fact that maximum employment is one half of the Fed's mandate, as well as the fact that given the employment situation has been strong by most measures, it has given the Fed the leeway to remain extremely hawkish. Ahead of this morning's print, Fed fund futures are pricing about a 74% probability of a 75 basis point rate hike later this month. The question is; what type of result do we need to get today in order to change that viewpoint?

Let's suppose for a few minutes. What if we get the following: NFP 150K and Unemployment Rate 3.6%? The initial response is likely to be risk positive as the algorithms will assume that the odds of a 75bp hike have been greatly reduced with the indication of slowing growth. The dollar will sell off, bonds should rally a bit and people are likely to head into the weekend feeling a little better about themselves and their portfolios.

But will numbers like that really sway the Fed? Again, the lesson they are trying hard not to forget is that pivoting on policy before there is certainty that inflation is truly falling on an underlying basis is prone to much worse outcomes. I would be wary to believe numbers like that will have a long-term impact on the Fed's view.

Alternatively, if we see NFP 350K and Unemployment at 3.4% or 3.5%, especially if Average Hourly Earnings were to tick up to 5.4% of 5.5%, I expect that the market would push the probability of a 75bp rate hike up toward 90% with concurrent declines in both stocks and bonds and another leg higher in the dollar. If this were to be the case, it is very easy to see the Fed sound even more hawkish and the first hints of 100bps for September may well appear.

But, as I said, the data leading up to this are not strongly pointing in either direction. The only consistency we have had is every single Fed speaker has been adamant that not only is there more tightening to come, but that rates will remain higher for longer. The futures market is still pricing nearly 50bps of rate cuts to occur in 2023. I believe that is a mistaken view and expect that financial markets will need to adjust (read fall) further before this tightening cycle is finished.

Ahead of the data, the overnight session has seen a modest respite in the consistent selling from this week. In Asia, the Nikkei (0.0%) and Shanghai (0.0%) were essentially unchanged although the Hang Seng (-0.75%) continued its recent losing ways. Europe, though, has been a bit better with the DAX (+1.0%) leading the way and the CAC (+0.3%) and FTSE 100 (+0.5%) also in the green…finally. However, at this hour, US futures are pointing slightly lower, -0.15%.

Bond markets are mixed this morning with Treasury yields falling 1.1bps after rising 13bps yesterday. European sovereigns, though, are still under pressure with Bunds (+1.9bps), OATs (+2.4bps), Gilts (+3.5bps) and BTPs (+2.6bps) all struggling to find buyers. There is increasing talk in Europe that the ECB is going to hike 75bps, and the OIS market is currently pricing a 65% probability of that outcome. Personally, I remain skeptical, but the best argument is they recognize that Europe is heading into a recession quite soon and they need to hike as much as possible while they still can.

On the commodity front, oil (+1.8%) seems to have found a floor for now, responding to negative news from the Iran talks thus reducing the market's perception of Iranian oil coming back onto the market officially. NatGas (-2.1% in the US, -11.1% in Europe) is responding to the cooler weather in the Northeast and the news that the NordStream 1 pipeline will, in fact, reopen tomorrow after the maintenance has been completed. While it is still pumping at just 20% of capacity, that is certainly better than nothing at all. Gold (+0.5%) has edged back over $1700/oz but remains under extreme pressure from the strong dollar and high US rates. Copper (-0.7%), though, is still having trouble as the specter of weaker economic activity is weighing heavily on the red metal.

Meanwhile, the dollar is finally taking a breather and has softened vs. most G10 currencies. The euro (+0.45%), has rebounded and is today's leader but is still under parity. SEK (+0.35%) and NOK (+0.3%) are next in line with position adjustments driving the krona while the krone is benefitting from oil's bounce. Alas, JPY (-0.2%) cannot find a bottom yet, and USDJPY remains firmly above 140 with an eye to 145 I believe. At Jackson Hole, Kuroda-san was quite clear that there were no policy changes coming and the spread between US and Japanese 10-year bonds is now >300bps, a level that suggests more dollar buying is on the way.

EMG currencies are a bit less consistent with both gainers (HUF +1.4%, PLN +0.65%) and losers (PHP -0.6%, KRW -0.6%) with a lot in between. On the positive side, there was no news from either country and I think this is more a case of the high beta of EEMEA currencies showing off on the back of the euro's bounce. Regarding the won, softer than expected CPI readings have traders believing the BOK will be less aggressive going forward while the peso's fall, to a record low, has traders believing the central bank in Manila will be forced to hike rates more aggressively, and seem to be trying to push their case.

After the NFP, there are no more Fed speakers scheduled so given the holiday weekend, I expect that by lunch, latest, we will have seen all that is going to happen. In my mind, the trends remain firm for a stronger dollar, and we will need to see extraordinarily weak NFP data to change that view.

Good luck, good weekend and stay safe
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