SMBC Capital Markets, Inc.

fxPoetry

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Andrew Fately
Executive Director, Senior FX Marketer
Global Markets Marketing Department
andrew_fately@smbcgroup.com
Direct: +1 212-224-4532
Representative: SMBC Capital Markets, Inc.

Shocked and Amazed

Each month when the number's released
The hope is it will have decreased
But since Twenty-One
Each print has outdone
The last, as though loaded with yeast

45.8%!
German PPI rose 7.9% in the month of August which takes the year-on-year number up to 45.8%. Not surprisingly, this is the highest print in the history of the series which began in 1949. Clearly, energy costs continue to be a catastrophic problem in Germany, and Europe as a whole, and there is no obvious solution in the short-term. The bigger problem is that if corporate Germany cannot adjust their prices to reflect their costs, it may well lead to quite a wave of bankruptcies and a devastating recession starting in Germany and spreading across the continent. We have already seen the entire power sector of Germany crumbling with Uniper, formerly one of the largest essentially being nationalized. But this is true across the entire German corporate landscape as skyrocketing energy bills are forcing companies both large and small to cease operations. While the markets have priced for a certain amount of this trouble already, given the absurd policy concepts put forth by European leaders, I fear there may be many more yet to come. Again, regardless of what the ECB does, it is hard to feel confident owning the euro (-0.2%).

While all eyes remain on the Fed
The Swedes sought to jump out ahead
They shocked and amazed
As one point they raised
Their base rate, though growth they will shred

Which takes us to the main feature of this week in markets, central bank meetings. The Riksbank was the first of seven major central bank meetings this week, headlined by the FOMC (exp 75bps) tomorrow, but also including Brazil (exp no change), Japan (exp no change), the Philippines (exp 50bps), Indonesia (exp 25bps), Switzerland (exp 75bps) and South Africa (exp 75bps). The interesting thing about the Swedish move is that the krona is actually weaker on the day by about

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-0.45%, despite the surprisingly large move. In fact, the dollar continues to show broad-based strength vs. nearly every other currency as the narrative continues to be the Fed will be the most aggressively hawkish central bank around.

So, versus its G10 peers today, NZD (-0.8%) is actually the worst performer followed by NOK (-0.5%) and then SEK. But the whole bloc continues to suffer against the greenback and seems likely to do so until such time as the Fed indicates it sees an end game. Frankly, it appears that this movement is merely the ongoing manifestation of risk aversion, where the most risk sensitive currencies, of which AUD, NZD and SEK are at the top of the list, are simply suffering from the overall USD story. Meanwhile, in the emerging markets, the currency weakness is broad but shallow, with almost every currency softer, but the declines relatively small at -0.1% to -0.3%. The outlier is KRW (+0.3%) as the government and central bank step up dialog about preventing significant weakness.

Of course, the question of exactly what the Fed will do tomorrow remains top of mind around the world. Currently, the Fed funds futures market is pricing in a 20% probability of a 100bps rate hike although the OIS market is pricing in a 38% chance of that 100bp move. In addition, much attention will be paid to the newest dot plots as well as the SEP report as investors and traders will want to understand the Fed's current expectations. Futures are pricing a terminal rate of 4.5% in six months' time, with an eventual slide from there. But we have all heard numerous Fed members explain that one the terminal rate is achieved, there will be no quick rate cuts, rather rates will stay higher for longer to ensure that inflation is slain.

Quite frankly, of more interest to me is the BOJ meeting, where Haruhiko Kuroda has been completely unwilling to consider a change in monetary policy. Last night, CPI data printed at a higher than expected 3.0% headline, 2.8% core, and coming in above their 2% target for the 5th consecutive month, each higher than the last. In other words, it certainly doesn't appear as if inflation in Japan is about to revert to sub-2%, but Kuroda-san insists their policy is correct. While the yen has stalled during the past week, ever since the BOJ "checked rates" it certainly hasn't appreciated in any meaningful way. It would not be hard to envisage a scenario where the Fed maintains its current hawkish stance and the BOJ holds firm with the result that USDJPY tests, and breaks, the 145 level and begins its next leg higher (yen lower). But equally, I would be wary of any indication by the BOJ that policy changes may be appropriate if inflation continues to behave as it has recently, which would likely see a sharp decline in USDJPY. The market remains massively short yen, and a short squeeze on any chink in the YCC or NIRP armor would likely see a very significant position adjustment and a much stronger yen. At least temporarily.

It is for this reason that managing risk is so complex. When results are dependent on the unknowable comments of a single official, there is no way to have confidence in any view and exposures need to be carefully hedged.

As to the rest of the markets, risk is definitely under pressure again this morning. While last night, Asian equity markets were in the green (Nikkei +0.4%, Hang Seng +1.15%, Shanghai +0.2%), that was following the late day US rally. But Europe (DAX -0.7%, CAC -0.8%, FTSE 100 -0.1%) is all red as concerns grow over the impact of mooted energy and fiscal policies by European leaders and which seem destined to underperform their goals. US futures are also under pressure this morning, with all three major indices down about -0.35% or so.

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But I assure you, those selling stocks are not buying bonds with the proceeds. Treasury yields (+4.3bps and firmly above 3.50%) are actually performing far better than their European counterparts (Bunds +8.4bps, OATs +8.9bps, Gilts +12.7bps, BTPs +8.9bps) as the Riksbank move clearly spooked investors there. 2-year Treasuries are pushing right up to 4.0%, a level last seen in September 2007 and seem unlikely to stop until the Fed halts its current program. Arguably, the bond markets are the key driver with stocks following this story for now.

Commodity prices are generally lower, but not dramatically so this morning as the recession story continues to make the rounds. Oil (-0.4%) has fallen from earlier modest gains, while NatGas is flat on the day. Gold (-0.4%) continues to suffer from rising real interest rates and the strong dollar while copper (-0.6%) and aluminum (-1.1%) are both heeding the recession story as well.

Looking ahead to the rest of the day, Housing Starts (exp 1450K) and Building Permits (1604K) are the US story while we see Canadian CPI (exp 7.3%). Quite frankly, there is nothing to suggest that the recent dollar strength trend is going to change, so keep that in mind as you look ahead for your hedging.

Good luck and stay safe
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