SMBC Capital Markets, Inc.

fxPoetry

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Financial Earthquakes

He once said, "whatever it takes"
And by himself fixed the mistakes
Of Wim and Trichet
Thus, saving the day
Preventing financial earthquakes

Now he's the PM based in Rome
Instead of a central bank gnome
He wanted to quit
But bonds had a fit
So, Draghi won't leave his new home

Meanwhile, further north, the UK
Is having one hell of a day
Inflation was hot
But really twas not
As hot as Hg did display

The biggest market movement today has been in the European sovereign bond space as Italian BTPs rallied sharply and closed the spread with German bunds by 6 basis points, taking that all important fragmentation signal back below the 200-basis point level. Recall, this is the spread that has the ECB freaking out about its ability to maintain the Eurozone in one piece as if Italian debt becomes too expensive, the consequences of a default are unthinkable. This is the focus of Madame Lagarde's anti-fragmentation tool which is a fancy way of saying the ECB is going to buy BTPs and sell Bunds if the spread between them widens too much.

What, you may ask, has been the catalyst for this positive outcome in the bond market? Why, none other than Super Mario Draghi once again saved the day. This time he did not have to ad lib his famous phrase, "whatever it takes," instead he was prevailed upon by Italy's President Mattarella (and probably many other European leaders) to remain as Italian PM and keep things in order. Investors have been in love with Mario since 2012 and it is no different this time. The strong belief is that as long as he remains head of the technocratic government coalition in Italy, the country won't blow up, and in fact may make progress toward its long-term goals of reducing its debt/GDP ratio while restarting more meaningful economic activity. It seems like a lot of pressure to put on one man, but hey, that's why he wears an 'S' on his chest. Super Mario is back.

It ought to be no surprise that bond markets throughout Europe are having a banner day with Bunds (-5.5bps) the laggard compared to BTPs (-11.5bps) while OATs (-6.1bps) and Gilts (-9.1bps) all rally strongly as well. However, turning to Gilts, it seems a bit odd that they have rallied that much given the release of the June inflation data. Headline CPI printed at 9.4%, 0.3% higher than May's number and a tick higher than market forecasts. RPI (Retail Price Index), which is a broader measure in the UK, actually rose 11.8%! Keep these numbers in mind as we listen to BOE Governor Andrew Bailey explain that it is possible that a 50-basis point rate hike could be appropriate at the next meeting come August 4th, which would take the base rate all the way up to…1.75%. Now, as I often say, I am just an FX guy, not an economics PhD like virtually every central banker, but it seems to me that maintaining real interest rates at -7.65% (or -10.05% based on the RPI) is very unlikely to exert enough pressure to reduce inflation. Granted I was educated with the 'old' math, not today's enlightened version, but still, it feels like there is much work left to be done to effectively address the runaway inflation.

Spare a thought for the good people of the UK as well given the current blazing heat across their nation (as well as much of Europe). Yesterday, the mercury reached 40.5° Celsius (104.9° Fahrenheit) in London, an all-time recorded high. And while today there has been a respite, forecasts are for more extremely hot temperatures throughout Europe going forward. This is especially problematic as air conditioning, something most of us in the US take for granted, is not that common over there given the historically generally cooler temperatures. This situation will only serve to exacerbate the power problems in Europe and the UK as generating the electricity required to run air conditioners will utilize much of the natural gas that countries there want to put into storage for the winter. Of course, if President Putin reopens the NordStream 1 pipeline tomorrow and gas flows again, that will be a big help. But the early word is that while it will start up, the flow will be reduced dramatically, thus preventing Europe from adding to storage. I fear (little darlin') it is going to be a long, cold, lonely winter over there.

Aside from the bond markets, how have other markets been performing? Well, equities in Asia (Nikkei +2.7%, Hang Seng +1.1%, Shanghai +0.75%) all followed the lead of the US yesterday which rallied strongly, but European bourses have just had a change of heart, from modest gains to losses across the board after Russia's Foreign Minister, Sergei Lavrov explained, "*If* [the*] West delivers long-range weapons to Kyiv, geographical objectives in Ukraine will be advance even further."* Apparently, the recent US deliveries of HIMAR rocket systems have really been taking a toll on Russian supply lines and activities. US equity futures, which had also been modestly higher earlier in the session, turned lower on the comments as well.

Commodity markets are mixed this morning with oil (-1.4%) slipping a bit, but still above $100/bbl, while NatGas (+1.8% in the US, +4.6% in Europe, +26.7% in the UK) is seeing strong demand everywhere as temperatures remain high. Gold (-0.2%) continues to bat about with no real direction lately, but we have seen strength in copper (+1.9%) and aluminum (+2.4%) along with most foodstuffs.

Finally, the dollar is mixed this morning with only AUD (+0.2%) and NZD (+0.3%) stronger in the G10 while it is rebounding slightly against the rest of its brethren there with SEK (-0.3%) the worst performer. These levels are a change from earlier in the session and have been a response to the Lavrov implicit threats of an escalation. Not surprisingly, the CE4 currencies bore the brunt of the reversal in the EMG with PLN (-0.6%) and HUF (-0.4%) the worst of the bunch. But as you can tell, movement today has been far less dramatic than we have seen the past several sessions.

On the data front, today brings Existing Home Sales (exp 5.35M) after yesterday's lackluster Starts and Permits data. The Fed's vow of silence remains in place, so the dollar is likely to take its cues from the bond market as well as any additional headlines.

The current dollar weakness is, arguably, long overdue given the magnitude of the movement we have seen. However, I contend that we have not seen the top in the dollar, nor will we until the Fed changes its tune from its current hyper hawkish stance to one less concerned with high inflation and more tuned to weakening economic activity. My best guess is that is a Q4 event, but when it comes, look for the dollar to reverse course quickly. Today, however, my guess is we will continue to see modest weakness pervasive across most pairs.

Good luck and stay safe
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