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SMBC Capital Markets, Inc.

fxPoetry

August 10, 2022

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Great Debates

The seventeen women and men
Who meet every six weeks and then
Decide about rates
Amid great debates
Are rightly in focus again

Today's CPI may reveal
If seventy-five has appeal
Or if in its stead
The folks at the Fed
Think fifty will now seal the deal

Not only are investors on edge about today's CPI release, but so are politicians on both sides of the aisle as depending on the outcome one side will be able to say, 'we told you so.' The most recent forecasts according to Bloomberg are as follows:

CPI M/M	0.2%
CPI Y/Y	8.7%
-ex food & energy M/M	0.5%
-ex food & energy Y/Y	6.1%

Now, we all remember that last month the Y/Y number printed at 9.1%, its highest since November 1981, because the punditry has been writing not-stop on the subject since its release. Indeed, so have the political commentators as it has been used as a cudgel to attack the Biden administration. What is less remembered is that last month the core number printed at 5.9%, so if it comes in as expected, that would be a very bad sign for the Fed in their efforts to slow price growth. Yesterday we also received the news that Unit Labor Costs soared 10.8% in Q2, far higher than expected and an indication that the much-feared wage-price spiral may be developing.

At this point, it's not clear what else can be said about the subject given how much ink has already been spilled. However, from our perspective here, the most important issue is trying to estimate the two key reaction functions, that of the Fed and the market.

Regarding the Fed, we are set to hear from two of the more dovish FOMC members, Chicago's Charles Evans and Minneapolis's Neel Kashkari, so their comments will be closely scrutinized. In the past week we have heard from the dovish wing of the Fed consistently explaining that they are not yet nearly finished with their work and need to see convincing evidence that inflation is declining. I expect more of the same today.

The problem for the Fed is that the market is basically ignoring them on this subject and continues to price in rate cuts beginning next year on the assumption that a recession is coming and the Fed will be forced to respond by cutting rates. Underlying that assumption is the idea that a recession will quickly cool price pressures thus helping the Fed along their anti-inflation path. And maybe that will be the case. But…

One cannot rule out the possibility that we are entering a stagflationary environment, where economic activity slows, but prices don't follow. This will come about if supply constraints continue to support prices of stuff like energy, metals and other raw materials. Structural supply shortages of oil are built into the system already, and the dramatic increase in natural gas prices has resulted in the mothballing of a significant amount of fertilizer production. The impact of the latter has not yet completely been felt in agricultural markets but will become more evident as lack of fertilizer will result in smaller harvests and higher prices. And the Fed (and every other central bank) will be unable to solve that problem.

The point is, there is no easy policy solution available to address the current, and near-term future, state of the world. Trade-offs will need to be made which will take us well beyond economics and finance and directly into the world of politics. When we get there, trying to determine market movements becomes exponentially more difficult.

In the meantime, my best guess for the market's reaction function as it currently exists is; bad news is bad and vice versa. So, a higher-than-expected print will result in market participants recognizing that the Fed is not going to back off according to the currently priced timeline. More rate hikes will be priced in, both stocks and bonds will fall, and the yield curve's inversion will grow further, likely beyond 50bps for the 2yr-10yr Treasury spread.

Alternatively, a lower-than-expected result will have the opposite effect. Interest rate traders will get even more excited and reduce the height of the peak Fed Funds rate while taking futures back to a 50bp expectation for September. The bond market will see the curve steepen with the inversion shrinking and equity markets will fly higher.

If pressed, I believe that we are likely to see an in-line headline print but a higher-than-expected core print, which after some toing and froing is likely to result in a modest risk-off session. In this case, I feel like the dollar, which is broadly softer this morning, is likely to regain its footing. One man's view.

Ahead of the number, risk assets have been less robust after yesterday's weakness in the US. Asian equity markets fell across the board (Nikkei -0.65%, Hang Seng -2.0%, Shanghai -0.5%) as tech shares there suffered on the back of yet another chipmaker (Micron Technology) reporting weaker than expected earnings and downgrading forecasts. Europe cannot make up its mind with no market having moved more than 0.1% in any direction although US futures seem somewhat upbeat with all three major indices higher by about 0.3% at this hour.

Bond markets are also mixed with Treasuries (+1.5bps) under some pressure along with gilts (+1.6bps) but Bunds (-1.0bps) finding bids and OATs (+0.4bps) barely moving. Here, too, traders and investors are anxiously awaiting the CPI data.

Oil prices have slipped (-1.5%) after a pipeline from Russia to Eastern Europe, which had been temporarily closed on some technicality, has now reopened. NatGas (-0.5% in US, +5.1% in Europe) is sliding here as the heatwave is forecast to break while in Europe no end is in sight. On top of that, the Rhine River's depth has been falling to the point where it is expected to become impassable for coal and oil deliveries by Friday, thus resulting in even more demand for gas. Turning to the metals markets, the picture is mixed with gold (-0.2%) continuing to consolidate its recent gains while copper (+0.5%) seems intent on taking back the losses it suffered in June and early July.

Finally, the dollar is a touch softer overall with CHF (+0.5%) the leading gainer in the G10 space followed by NOK (+0.45%) and NZD (+0.35%). The franc seems to be benefitting as a haven this morning while NOK is reacting to a much higher than expected CPI reading and growing expectations of further policy tightening by the Norgesbank. Meanwhile, kiwi is trading around technical factors with nothing fundamental to note.

In the emerging markets, overnight saw broad weakness amid the APAC bloc (THB -0.55%, KRW -0.5%) as investors offloaded risk positions ahead of the CPI this morning and in the wake of yesterday's risk off move. However, the EEMEA currencies are performing a bit better (CZK +0.55%, ZAR +0.5%, PLN +0.3%) as the koruna is also seen to soon benefit from tighter policy after CPI there rose to 17.5%, while business confidence edged higher in South Africa and Polish wage growth has traders looking for tighter policy by the central bank there. (As an aside, is anybody looking for any central bank to loosen in the near term?)

And that's really the day. So expect lots of breath holding until the print, and then the reactions will depend on the data.

Good luck and stay safe
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