SMBC Capital Markets, Inc.

fxPoetry

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Jay and His Minions

Apparently, when you lock down
Your people in every large town
The impact on both
Your markets and growth
Is likely to tarnish your crown

It cannot be that surprising that China's Q2 economic data was awful given that they essentially halted a good portion of their economy from any activity based on their zero Covid policy. In fact, arguably, one needs to question the analysts who were anticipating that GDP could grow 1.2% in Q2 given that policy in place. In the event, the data released last night showed that GDP grew just 0.4% in Q2, a -2.6% annualized decline on a quarter over quarter basis and has basically sealed the fate of President Xi's goal of 5.5% GDP growth this year. Ain't gonna happen. The real question is how the government there will respond. Remember, the 20th National Congress of the Chinese Communist Party convenes in November and President Xi will be looking to alter the rules to get reelected for a third term, and essentially for life. The inability to uphold his goals of prosperity for all will weigh against him, and apparently, it is not a guaranty that he is reelected, although he is still the favorite. The point is, you can be sure that there will be a lot more fiscal and monetary stimulus coming to get the economy back on its feet.

Xi, though, has one other problem to consider, and that is the slow-motion destruction of the property market in China. Last night's data showed that Property Investment fell a more than forecast -5.4% in June while Residential Property Sales collapsed by -31.8%. Stories are rife about mortgage "strikes" where people who had been paying mortgages for homes that were not yet complete have stopped doing so given the long delays in the completion process. Recall, China Evergrande began its collapse last year, which has been followed by numerous other developers who have failed to make interest and principal payments on outstanding bonds. Property makes up more than 25% of Chinese economic activity, and the bubble that was inflated by the government to improve the optics of Chinese GDP has been deflating, much to Xi's chagrin. Look for further problems in this economy and for the renminbi (0.0% today, -6.3% in past 3 months) to continue as a relief valve and slowly grind lower over time.

Ere yesterday, markets had thought
A hundred bp rate hike was sought
By Jay and his minions
But now those opinions
Have changed based on what Waller taught

Instead, he and Bullard agreed
That seventy-five's what we need
So, stocks turned around
While bond yields were down
Though as yet, there's naught been decreed

Turning closer to home, after Wednesday's blow out CPI print, the market immediately started pricing in a full percentage point increase in Fed funds at the end of the month. Comments from three separate FOMC members (Bostic, Barkin and Daly) did nothing to dissuade traders from that view. However, yesterday, Governor Waller, one of the more hawkish members on the committee, made explicit that he felt 75bps would be correct unless today's Retail Sales and next week's housing data were so strong as to imply that price pressures would continue to rise. He was followed by both Bullard and Mester, each of whom are known as quite hawkish, and each who agreed that 75bps was the right move. Adding to this was the new Fed Whisperer, the WSJ's Nick Timiraos, whose article yesterday afternoon concurred that the board was looking at 75bps only. Recall Timiraos wrote the article in June, during the Fed's quiet period, that changed the market outlook from 50bps to 75bps, so he has a great deal of market credibility, perhaps more than the Fed itself!

At any rate, that combination of comments was enough to halt the bloodbath in equity markets, as well as in commodities and helped reduce the inversion in the yield curve by a bit, although it is still 18bps inverted this morning. I have a feeling this discussion of 75bps vs. 100bps is a bit like rearranging the deck chairs on the Titanic. It doesn't really matter. The reason is there is a very strong case to be made that the exact timing of those rate hikes is not nearly as important as the terminal rate of where Fed funds peak in this cycle. Right now, the market is pricing that point at 3.58% in February 2023, basically another 200bps higher. But compare that to the June Dot Plot, where the median expected 2023 rate was 3.75% with nine FOMC members above that rate and 5 looking for above 4.0%.

Nothing about Wednesday's CPI report indicated that inflation was going to moderate in the near-term. While gasoline prices have fallen in the past month, that is pretty much the only part of the basket that has done so. And PPI continues to rise and add pressure to corporate margins which will be addressed by further price hikes. Too, the comps for the next three months are quite low, so mathematically we are likely to see headline CPI continue to rise. If the Fed is truly focused on beating inflation, my sense is they will need to raise interest rates to well above 4% and keep them there for a while. The market is not pricing that scenario at this point. While that would almost certainly drive the economy into recession, Chairman Powell has been quite clear he is comfortable with that outcome. In the end, risk assets seem likely to have further to fall, at least in my view.

Ok, a quick rundown of markets ahead of this morning's Retail Sales (exp 0.9%, 0.7% ex autos), Empire Manufacturing (-2.0), IP (0.1%), Capacity Utilization (80.8%) and Michigan Sentiment (50.0) shows the following:

Equity markets were mixed in Asia (Nikkei +0.5%, Hang Seng -2.2%, Shanghai -1.6%) after the Chinese data disappointed and further pressure was brought to bear on TenCent thus igniting fears of another tech crackdown there. Europe, though, is feeling better (DAX +1.6%, CAC +0.6%, FTSE 100 +0.8%) perhaps on the fact that the Eurozone Trade deficit was 'only -€26.0B in May, rather than the -€35.0B expected. Or perhaps because Signor Draghi's resignation was rejected by Italian President Mattarella thus preventing the Italian government from collapsing and fears of a more anti EU party taking power.

That said, Italian BTPs (+2.9bps) are still widening vs. Bunds (-1.2bps) and almost certainly giving Madame Lagarde indigestion. That spread, currently 211bps, is the key metric for the anti-fragmentation process, and above 250bps is likely to cause some real ructions. French and UK bonds are little changed on the day, while 10-yr Treasury yields (-2.0bps) continue to trade either side of 3.0% as the market continues to try to determine if inflation or recession is the future. (Both I fear).

Commodity markets are in the recession camp led by copper (-0.9%), which has fallen 30% since the beginning of June. Oil (+1.9%) which is bouncing today after there was no Saudi commitment to raise production following the meeting between President Biden and Saudi Prince MBS, is still down more than 20% from its recent peak in early June, also a harbinger of recession. Gold (-0.1%) continues to be a dog, weighed down by rising interest rates and a strong dollar, although its value in other currencies remains far more robust.

As to the dollar, while it is slightly softer vs. its G10 counterparts today (CHF +0.4%, SEK +0.4%, EUR +0.35%) that is simply consolidation after a very strong run higher over the past several weeks. In fact, compared to last Friday, the dollar remains stronger vs. each of its G10 counterparts. In the Emerging markets, the picture has been more mixed with KRW (-1.1%) and PHP (-0.5%) leading the way lower while HUF (+0.9%) and PLN (+0.75%) have been rebounding. The won story is one of rising Covid cases and concerns over slowing growth amid a strong dollar environment. The peso suffered despite a surprising large 75bp rate hike by the BSP last night as the market clearly doesn't believe that is enough to address the rising inflation pressures there. On the plus side, the forint has benefitted from government policies that seem to be designed to appease the EU, thus opening up the aid it is due and that has been stalled by disagreements over Hungarian judicial and regulatory policies, while the zloty appears to be benefitting from central bank comments that further rate hikes will be forthcoming in September.

On top of today's outpouring of data, we hear from 3 more Fed members, Bostic, Bullard and Daly, two of whom indicated 100bps would be reasonable. All of them, however, will have the benefit of seeing the data before they speak, so that could inform their comments. But once they are done this afternoon, the Fed heads into its quiet period ahead of the meeting on the 27th.

While the dollar is under some pressure this morning, the bigger trend remains intact, and as long as the Fed keeps to its hawkish stance, the dollar should continue to outperform.

Good luck, good weekend and stay safe
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The views expressed are his own and may differ from Research.