SMBC Capital Markets, Inc.

fxPoetry

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Under a Cloud

A nation with history, proud
Has seen its poor pound getting plowed
The market's decided
That Kwarteng's misguided
And Brits now live under a cloud

Meanwhile further south on the Med
Italian elections have spread
A constant drumbeat,
By EU elite
That history's end is ahead

As eventful as last week seemed to be, and it was eventful, the weekend brought even more fireworks in the guise of Italian elections where Giorgia Meloni, leader of the Brothers of Italy party, led her coalition to a strong victory capturing both houses of parliament there. Naturally, because she is right-leaning, the EU elite is terrified. Not dissimilar to the reaction to the election of President Donald Trump in 2016, expect to hear a constant outpouring of all the evils that she and her party represent. And yet, her coalition garnered one of the largest majorities in Italian history. Clearly, her message resonated with a lot of people there. It is still far too early to make any judgements on what her policies will be and how they will perform, but the early returns, at least based on the Italian equity markets, are mildly encouraging as the FTSE MIB (+0.3%) is the only equity market higher around the world today. There are pundits who have claimed that the Italian election results are helping to drive the euro lower (-0.4%) but let's face it, the euro has been falling sharply since May of last year, long before the Italian election was even on the table. And frankly, virtually whatever PM Meloni does, it can't have a more negative impact than the actions of UK PM Truss and her faithful Chancellor of the Exchequer, Kwasi Kwarteng.

Turning to the UK, as I write at 6:30 this morning, the pound (-1.3%) is much lower than Friday's close, but much higher than the lowest levels plumbed overnight where it hit a new historic low level of 1.0350. Now, that happened at about 11:00pm in NY, so nearing lunchtime in Asia when liquidity, never great for GBP in Asia at the best of times, is even more sparse. While it has since climbed back from those levels, there is no reason to believe it cannot revisit them as the week progresses. Of greater concern for Chancellor Kwarteng is the fact that apparently every potential buyer of UK Gilts has left the market. This is evidenced by the fact that Gilt yields have exploded higher (+49bps in the 2yr, +27bps in the 10yr), far outpacing the much higher yields seen throughout global bond markets. Not only that, but the OIS markets are now pricing for a 125bp rate hike by the BOE in November with a total of nearly 350bps of hikes over the next year. It seems that the market's initial verdict on borrowing money to pay for fiscal policy easing is quite negative.

The punditry, as it searches for rationales for the current volatility, continues to point its fingers at the extreme pace of the Fed's rate hikes and how that is upsetting the apple cart. However, the reality is that the US was hardly alone in maintaining ultra-easy monetary policy for the past decade plus, in fact it was the global norm with negative interest rates becoming the rule throughout Europe as well as Japan. Any transition away from that policy was always going to be difficult, and it appears that we have reached the point where the central banks may be losing control over their markets and mandates. I have long maintained that a day would come where the Fed, or any central bank really, would act in some manner and the market would essentially ignore the action as irrelevant for the current situation. Remember, central banks have limited toolkits, with essentially just two main levers, interest rates and their balance sheet. After that it moves on to reserve requirements and then regulations for things like liquidity buffers. And while those latter tools are very effective at directing commercial and investment banks to do as the central bank asks, investors generally do not care. So, do not be surprised if the market reaction function going forward is not to the central banks' liking. Just sayin'.

Certainly, one would have to believe that central banks are not enamored of today's market action as we are seeing yet another risk-off session. Asia followed last week's US selloff (Nikkei -2.65%, Hang Seng -0.45%, Shanghai -1.2%) while Europe is also under pressure (except Italy) with the DAX (-0.2%), CAC (-0.2%) and FTSE 100 (-0.85%) suffering. In truth, given the IFO data release from Germany this morning (Business Climate 84.3, exp 87.0; Expectations 75.2, exp 79.0), I would say the German market is doing quite well. As to US futures, negative is the word here as well with all three major indices looking at -0.6% declines or worse.

As mentioned above, government bonds are clearly no haven today with yields higher everywhere around the world. Treasuries (+9.8bps) are pressing to new highs on their yields for the move and back to levels last seen in March 2010 and showing no signs of halting anytime soon. As to the rest of Europe, Bunds (+7.1bps) are the best performer with OATs (+9.1bps) and BTPs (+14.9bps) both falling further. The Bund – BTP spread is now up to 238bps, edging closer to the 250bp level which is widely believed to be the ECB's first line in the sand. We shall see. One other noteworthy mover overnight was South Korea, where KGB's fell, and yields jumped 16.7bps.

The market has decided that the coming recession (has it already arrived?) means that commodities have no demand left regardless of the supply situation. Oil (-1.0%) today is continuing its decline after a nearly 5% decline on Friday. NatGas (-2.6%) is also under pressure with Europe (-7.9%) and the UK (-15.6%) falling even more sharply, clearly responding to fears of a major economic slowdown. Gold (-0.3%) is a relative winner, and versus other currencies continues to rise, while copper (-1.0%) and aluminum (-1.0%) are also under pressure on the recession story. Perhaps more interesting is the weakness in agricultural products as despite recession, I would assume people still need to eat.

Finally, the dollar knows no bounds, at least not yet. In the G10, rivaling the pound's weakness is NOK (-1.2%) which is suffering alongside the price of oil, while CHF (-1.0%) and JPY (-0.7%) are also under pressure with the former starting to feel the heat from declining stock prices (remember the SNB is one of the largest equity holders in the world) while the yen is shaking off its post intervention strength and looking like it is going to retest the previous lows at 145.90.

~~Sub~~Emerging markets are also in thrall to the stronger dollar with KRW (-1.5%) starting to really break out as investors flee both the equity and bond markets there. THB (-1.1%) is next in line followed by PLN (-0.95%), HUF (-0.85%) and INR (-0.8%). In truth, there is no specific storyline here other than the demand for dollars to repay bonds and interest remains extraordinary and show no signs of abating.

On the data front this week, the schedule is limited:

Today	Chicago Fed National Index	0.23
	Dallas Fed Mfg	-10.0
Tuesday	Durable Goods	-0.3%
	-ex transportation	0.2%
	Case Shiller Home Prices	17.35%
	Consumer Confidence	104.5
	New Home Sales	500K
Thursday	Initial Claims	215K
	Continuing Claims	1383K
	Q2 GDP	-0.6%
Friday	Personal Income	0.3%
	Personal Spending	0.2%
	Core PCE	0.5% (4.7% Y/Y)
	Chicago PMI	51.8
	Michigan Sentiment	59.5

Source: Bloomberg

Arguably, Friday's PCE data is the highlight of this slate, but more remarkably, we hear from fourteen Fed speakers, including Chairman Powell twice amongst the twenty-one different scheduled events. I guess they want to make sure they get their message across.

Nothing has changed the narrative at this point, with the big events in the UK and Italy simply reinforcing the idea that the dollar remains the safest haven around. At this stage, if the euro were to fall to 0.90 in the next month it would not surprise me. I guess the biggest question is how long can the central banks, and more importantly the governments, of the G10 withstand the pressure of an ever-increasing dollar? Is the time for Plaza Accord 2.0 coming soon? For now, nothing has changed my view that the dollar could very well rise much further.

Good luck and stay safe
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