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.

Passé

Apparently in the UK
The story 'bout growth's gone astray
So, rate hikes assumed
May now well be doomed
And QT, too, may be passé

This morning, talk in the UK has increased regarding stagflation after the flash PMI data showed a significant decline in both the Services and Composite readings. While both remain above the key 50.0 level, their respective declines from 58.9 =>51.8 in Services and 58.2 =>51.8 for the Composite are amongst the steepest declines on record and disturbingly close to recessionary levels. And yet there is no indication that price pressures are declining. This puts the BOE into quite a bind. The standard policy prescription for the current rising inflationary environment (remember, CPI just printed 9.0% there) is to raise interest rates enough to slow demand and, ~~theoretically~~ hopefully, price pressures. However, with growth slowing so rapidly, the central bank policy response would be to ease policy to support the economy. This is a perfect example of the fate that seems likely to befall almost every western nation. Rising prices and slowing growth are the combination that no central bank is prepared to address, at least not on a political basis, because to fight one is likely to exacerbate the other. And politically, both situations are kryptonite for elected officials.

At Davos, said Madame Christine
Recession, is not, here, foreseen
But data keeps showing
Activity's slowing
Though prices remain on caffeine

The European version of the PMI data was less awful than that in the UK, but still showed declines across the board. However, any discussion of recession in the Eurozone will not be countenanced by Madame Lagarde as she categorically denied its possibility in an interview as she hobnobbed amongst the global gliteratti in Davos. Essentially, now that she has formally explained that the ECB is going to be exiting NIRP by September, there is no room for her to pull back in the event the economic chips fall in an awkward direction. But remember, raising the overnight interest rate to 0.00% is hardly a sign of ‘tight’ money. In fact, it is still ridiculously accommodative policy. The idea that ZIRP is the policy that is going to help slow inflation in the Eurozone is laughable. However, as mentioned above, the ECB finds itself in the exact same situation as both the BOE and the Fed, forced to tighten monetary policy to combat inflation as growth slows.

In the end, all of these central banks are very likely to blink. Politically, while inflation is awful, recession is worse. And every central bank, despite their vaunted ‘independence’ is a political animal. The only question is at what point will they change their current tune of tighter policy. The BOE will be a great study as it seems the evidence of slowing growth is more prevalent there than elsewhere, yet. The market has already removed one full hike from the cycle over the next year and dismissed any chance of more than a 25bp move in June. The pound (-0.6%) has suffered, Gilts (-8.0bps) have rallied and UK stocks (-0.2%) are under some pressure. Who will be next?

Ok, let’s see how markets are responding to this news. Risk is not really in favor this morning despite yesterday’s equity rallies. There was no follow-through overnight with the Nikkei (-0.95%) the best performer compared to the Hang Seng (-1.75%) and Shanghai (-2.4%). It seems that sentiment was pretty badly affected by a weak earnings report from Snap which has simply called into question the whole tech sector again, at least with respect to valuations. US futures are all lower with the NASDAQ (-1.65%) leading the way. One thing about which there has been plenty of ink spilled lately is the idea that there should be a strong bid for equities as asset allocation portfolios need to rebalance and buy stocks after the recent carnage. And yet…

On the bond front, Treasury yields, too, are lower, down -3.4bps, but the Continent has seen much less movement with nothing having moved more than a basis point in either direction. Granted, the PMI data there was less dramatic, although it did indicate slowing momentum. Perhaps Madame Lagarde’s wisdom has been enough to prevent further concern.

In the commodity sphere, oil (+0.3%) has been trading on both sides of unchanged today and arguably, continues to trade within a range of 105/115 needing to break either side to get players excited. NatGas, however, continues to rise, up a further 1.85% this morning and now pushing close to $9.00/mmBtu. I expect that the arbitrage between European and US natural gas prices will continue to close that gap, which is currently nearly $18/mmBtu. NatGas prices in the US have much further to rise. The precious metals have been holding their own with gold (+0.2%) and silver (+0.5%) both retaining their recent gains. However, on the back of the weaker PMI data, both copper (-1.1%) and aluminum (-1.25%) are under pressure. Finally, there is no respite in the agricultural space with prices there continuing to rise.

As to the dollar, mixed is the best description, although it appears there are a few more laggards than gainers. After the pound, NZD (-0.55%) and AUD (-0.5%) are the worst G10 performers as the commodity space comes under pressure, while on the plus side, JPY (+0.35%) is leading the way as it follows 10-year Treasury yields. The euro (+0.15%) has maintained its gains from yesterday’s ECB blog post but has not been able to extend them in any serious manner. EMG currencies are also mixed with ZAR (+0.5%) the leader after a major union agreed a new contract avoiding a possible strike, while TRY (-1.1%) continues to suffer from its current policy stance of cutting interest rates into the highest measured inflation in the world at 70.0%. In truth, it is remarkable the lira is not weaker. However, away from those two, movement has been very muted with gainers and losers of 0.2% or less.

On the data front, we also see those flash PMI's here this morning (exp 57.7 Mfg, 55.2 Services) and then New Home Sales (750K). Arguably, of far more importance will be Chairman Powell's comments at an Economic Summit although there will be no Q&A. Yesterday's comments from Atlanta Fed President Bostic had no impact on markets.

Quite frankly, I would have expected the dollar's weakness to have been a bit more prolonged after an 8+ week rally, and it still can be. But as of right now, there is no indication that anyone is changing their medium and longer term views about the Fed's future activity. it is only at that point, when the Fed blinks, that we should see a more complete reversal of the dollar's gains, as well as a reversal of all of those equity losses.

Good luck and stay safe
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The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.