SMBC Capital Markets, Inc.

fxPoetry

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Quite Sticky

While parsing the numbers is tricky
And trying not to be too picky
The price of the stuff
That's bought off-the-cuff
Did fall, but the rest is quite sticky

A quick review of the CPI data (HT @inflation_guy) from yesterday shows that while there was clearly some positive news on the inflation front, it is hardly yet time to celebrate that inflation is dead. In a nutshell, the categories that declined were airfares, apparel, energy (obviously) and lodging away from home. However, prices for virtually everything else continue to rise, and rise quite substantially. Arguably, the most critical of these prices, shelter, continues to move higher and is unlikely to change that trajectory in the near-term. And let's face it, people are celebrating because the annual inflation rate fell to **8.5%,** a level that is still more than 4x the FOMC's target of 2.0% inflation. That makes little sense on the surface.

The upshot here is that the probability of a 75bp rate hike in September has fallen, with the futures market now pricing in a 45% chance of that move, down from 75% probability before the release. However, there is still a long time between now and the next FOMC meeting, and we are going to see further important data readings including PCE, NFP and the August CPI. In addition, we will hear from Powell and friends at Jackson Hole in 2 weeks, so nothing is set in stone.

While my pre-release estimates were off, my explanation of the reaction function was spot on. The interesting thing is that while the bond market retraced the bulk of the initial euphoric move higher (yields lower), the stock market remains immune to reality. In fact, this morning the WSJ declared a new bull market in the NASDAQ because it has rebounded 20% from its recent lows. (It strikes me that the terms bull and bear markets have lost a lot of their meaning lately as a slavish adherence to the 20% rule is rendered meaningless by higher volatility.)

Finally, the two Fed speakers yesterday remained adamant that one data point is not sufficient to change their views and as Kashkari said, *"the Fed is far away from declaring victory on inflation*," and recession "*will not deter me*" from achieving the 2% goal. At face value, these are strong statements from one of the most dovish members of the Fed and arguably imply that there are a number of rate hikes yet to come. In fact, his view is Fed funds needs to be at 3.9% by the end of this year, another 150bps of tightening and far more than currently anticipated by the market. But the fact that the equity market continues to trade based on falling interest rates in the future implies, to me at least, that the Fed's credibility is pretty threadbare.

With CPI out of the way
There's nothing else likely to sway
Opinions for weeks
Til Chairman Jay speaks
So, stocks ought move up and away

Now that this critical inflation reading is in the books, traders and investors (and algos) will be looking for any new tidbit on which to base their decisions. Given the default setting of the media, that equity values should rise infinitely, and the relatively limited opportunities for negative economic news for at least the next two weeks, I expect that we are going to see some serious risk appetite appear. While the few Fed speakers scheduled between now and Jackson Hole are likely to protest the view that inflation is dead and reiterate that a recession is acceptable if it helps reduce inflation, we have already ascertained that the market does not really care that much about what they say. Just remember that the sharpest equity rallies are those that take place during bear markets, and despite the WSJ's declaration, I contend that is all we are currently witnessing.

But witnessing it we are, as Asian markets (Nikkei closed, Hang Seng +2.4%, Shanghai +1.6%) rallied in the footsteps of the US activity yesterday. Interestingly, European markets this morning are more red than green (DAX 0.0%, CAC -0.2%, FTSE 100 -0.3%) despite a lack of new data or any real comments of note. Perhaps there is a limit to how high stock prices can rise given the backdrop of war and outrageous inflation. US futures are all pointing slightly higher at this hour, +0.3%ish, but obviously, that can be erased in the blink of an eye.

In the bond market, Treasury yields have edged down 0.9bps this morning, although are just 1.4bps lower than where they were prior to the CPI print yesterday morning. There was an immediate 15bp decline in yields which was completely reversed by the end of the day yesterday, certainly not a sign that bond investors yet believe inflation is dead. As to the shape of the yield curve, after blowing out to -58bps briefly yesterday, it is back to -43bps, still hugely inverted. In Europe, yields are higher across the board (Bunds +2.4bps, OATs +2.0bps, Gilts +4.7bps) as concerns continue to grow over energy induced inflation there. The big story is that the water level in the Rhine River is expected to become unnavigable as soon as tomorrow, which means that coal and oil shipments (as well as everything else) will not be able to make it to the southern state of Baden-Wurttemberg and its associated industries.

Interestingly, despite the decline in the energy complex in the CPI report, this morning oil prices are bouncing (+0.9%) and remain well above key technical support although below $100/bbl. NatGas (+3.3% in US, +3.0% in Europe) is also well supported on the back of higher oil prices as well as the switching that is likely to occur if oil becomes scarcer in parts of Germany due to the Rhine. Gold is flat, having seen a rally and reversal yesterday and continues to trade either side of $1800/oz while both copper (+1.15%) and aluminum (+0.5%) are rebounding, potentially as a signal that demand is anticipated to rise if the central bank tightening schemes are nearing their end.

Turning to the dollar, yesterday's price action was completely expected based on the CPI outcome, with the greenback falling against virtually all of its peers and many currencies rising more than 1%. This morning, the weak tone remains but to a lesser extent with the euro (+0.4%) leading the pack in the G10, although most of the bloc is higher by similar amounts, except for the pound (-0.1%) which is suffering from growing concerns that the leading PM candidate, Liz Truss, is discussing a change to the BOE mandate which can only be too increase government oversight.

The same was largely true with respect to the EMG bloc, with the dollar falling sharply yesterday against virtually all of these currencies and continuing lower today. This is entirely the US rate story, with individual country issues far less important. One thing to note is that Banxico is expected to raise their base rate by 75bps this afternoon, so watch there.

On the data front today is Initial Claims (exp 265K and creeping higher), Continuing Claims (1420K) and PPI (10.4% headline, 7.7% ex food & energy). But PPI is a secondary number at the best of times and with the CPI print under our belts, it would have to be extraordinary to have a large impact. SF Fed president Daly will be speaking this evening, but she has already told us her views that they have further to go and risk markets just don't care.

At this point, I see no reason for the dollar to reverse course in the near term, nor equities either, as traders and investors remain convinced that the Fed is going to turn tail soon. I disagree with that assessment, but until it is clear that the Fed truly is going to continue to tighten policy in the face of a recession, markets are set on their path; higher stocks and lower dollar.

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.