SMBC Capital Markets, Inc.

fxPoetry

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Kuroda-san Smiles

Prices in Japan
No longer running higher
Kuroda-san smiles

It was not that long ago when the punditry was convinced that the BOJ was going to be forced to recant on their current policy statements and begin to reduce accommodation like every other Western central bank. CPI had risen to 2.1% and the yen had fallen to its weakest point in more than 20 years. The disparity between the BOJ's actions and those of the Fed (at least what was expected of the Fed) were large and growing, and when Kuroda-san reiterated that YCC was still appropriate alongside NIRP there was much scoffing.

Turns out, at least so far, that Haruhiko has had the last laugh. Last night Tokyo CPI data was released at a slightly softer than expected 1.9% Y/Y for the ex-Fresh Food reading. This is the first indication that price pressures are, at the very least, moderating from their recent sharp rise. While this is not the official data the BOJ follows, the relationship between the Tokyo and National data is extremely tight. If prices aren't rising too quickly in Tokyo then they are likely not rising too quickly anywhere in Japan.

This begs the question as to what to think about the yen. Certainly, we didn't learn anything in the overnight session where the currency remains unchanged on the day. But stepping back a bit, the relationship between the yen and the 10-year US Treasury remains incredibly tight. (weekly correlation since March is 0.862) The thing is, the 10-year Treasury has seen its yield decline some 40 basis points in the past month, during which USDJPY fell from its highs above 131 to its current level at 127. There is no reason to believe this relationship is going to change soon which means that if Treasury yields continue their retreat, look for USDJPY to do the same thing. Similarly, if Treasury yields were to reverse their recent course and rise again, I expect to see USDJPY follow them higher.

So, what do we think about Treasury yields? First, remember, I am just an FX guy, so take this for what it's worth. However, my observation is that the US economy is clearly slowing down and while every data point hasn't indicated as such, enough continue to show weakness, especially the forward-looking indicators, to have convinced me this is the case. There are several causes, notably the relative reduction in fiscal stimulus as well as a certain amount of demand destruction on the back of the dramatic rise in prices we have seen across the board in the US. Add to that Chairman Powell's effective promise to slow the economy and cause some pain on the employment side of the ledger and it appears that interest rate markets are beginning to price in the probability of slower terminal growth and lower terminal rates. Of course, yesterday's downward revision of Q1 GDP did nothing to hurt the pending recession case either.

Adding to this information is the fact that China continues its zero-Covid policy and Xi Jinping is clearly comfortable with a much-reduced pace of growth there. European growth impulses, never the brightest in the best of times, are suffering as well and the ECB continues to claim they will be tightening policy to address the out-of-control inflation situation there. (Of course, THEY ARE STILL BUYING ASSETS IN THEIR QE PROGRAM, so perhaps that may not actually occur.) Nonetheless, the weight of evidence points to slowing US and global growth. And that, my friends, hints at US yields declining further, at least in the shorter term. However, there is no indication that energy prices are going to decline given a decade of underinvestment in energy that works and massive overinvestment in intermittent sources of energy. Eventually, that is going to be a very bad outcome for everyone, slowing growth and higher energy prices. We've seen this movie before, at least those of us old enough to have seen the original Star Wars when it was first released. Equity markets will likely suffer further indignations and given Jay Powell is clearly not Paul Volcker, at some point the bond market will revert to its role as vigilante du jour and yields will move much higher. But not before another test of 2.25%-2.50% I think. So, for USDJPY, a move toward 122 seems viable during the summer, but beyond that, I see a much more powerful move to levels not seen in this century. (140 anyone?)

Ok, heading into the Memorial Day weekend, it has been a quiet session and I expect no less from the US. Equity markets have continued their rebound with Asia (Nikkei +0.7%, Hang Seng +2.9%, Shanghai +0.25%) and Europe (DAX +0.7%, CAC +01.8%, FTSE 100 +0.1%) all in the green. The outlier here, Hong Kong, was on the back of better than expected results from Baidu and Alibaba. At this hour (7:10am) US futures are modestly in the green as well, with the NASDAQ (+0.5%) the leader. That said, I couldn't help but notice the article in the WSJ this morning that more than 10% of the SPACs that listed since last year have issued going-concern warnings, yet another indication that the various Fed inflated bubbles are popping.

Bond yields continue to soften with Treasuries (-2.2bps) looking to make another run at 2.70%, a key technical support level, while in Europe, the bond rally is more robust. Gilts (-6.2bps) lead the way but Bunds (-4.7bps) and OATs (-5.3bps) and the PIGS are all seeing similar yield declines. Maybe the weakening growth story is spreading.

Commodity prices have been choppy but right now oil (-0.45%) is a touch softer although it has been rallying for the past week. NatGas (-3.2%) is also under some short term pressure, but recall, it has rallied nearly 200% in the past year, so a little respite is no surprise. NatGas inventories are at multi-decade lows so structural support remains. Gold (+0.45%) is continuing to bounce and we are seeing strength in copper (+0.4%) and aluminum (+0.7%) as well. Arguably, the metals' strength is based on the dollar's general weakness.

Speaking of the dollar, AUD (+0.7%) and NZD (+0.7%) are leading the way in the G10 as commodity prices (ags are higher as well) are seen as quite positive and the increasingly hawkish message we are getting from those central banks is adding support. Beyond those, however, movement in the G10 has been far more muted with NOK (+0.25%) the next best performer and the rest of the bloc just +/-0.2%. In fact, the euro is today's laggard at -0.2%.

EMG currencies have seen far more gainers than losers with KRW (+0.9%) and TWD (+0.5%) leading the way. While the won's gains were a product of the broad risk-on sentiment we are seeing, the Taiwan dollar clearly benefitted from the announcement that the US is planning closer economic ties with the country. But the rest of the APAC bloc was marginally higher and today's laggards have been EEMEA currencies, following the euro's soft tone, but none of which have fallen even -0.25%.

On the data front, Personal Income (exp 0.5%), Personal Spending (0.8%) and core PCE (4.9% Y/Y) are all released at 8:30. Then, at 10:00 Michigan Sentiment (59.1) is out and that is likely to be the effective end of the session. As the holiday approaches, liquidity is going to dry up quickly once London goes home, so if you have things to do, get them done before lunch.

Good luck, good weekend and stay safe
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