fxPoetry

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A Slow Grind

Inflation's on everyone's mind
As early today we will find
If prices rose higher
Like they had done prior
Or if they fell in a slow grind

If high, watch for stocks to decline
And watch for the dollar to shine
But anything low
Will likely bestow
More stiffness to every bull's spine

Just think, the financial world is so excited that US CPI may have fallen to 8.0% in August that the bulls are running like it is summer in Pamplona. 8.0%! Somehow, that just doesn't seem quite so encouraging to me as a bullish signal. While Fed speakers are on hiatus until their meeting next week, that certainly hasn't prevented the analyst community from broadly disagreeing with everything that the Fed has explained over the past several weeks.

Fedspeak was quite clear, and universally so, that they are not close to being finished hiking rates, that once they achieve a level that appears to be appropriate to contain price pressures they will maintain that level for a long time, and that the idea of lower rates before 2024 is ludicrous.

Analystspeak is somewhat different. It seems to be focused on 75bps next week then maybe 50bps and 25bps for the last two meetings of this year with a short pause and then the beginning of a rate cut cycle sometime in Q2 or Q3 of 2023.

Now, it is certainly possible that the combined impact of the Fed's rate hikes to date (which arguably haven't really filtered through the economy yet) and the reduction in the size of their balance sheet could lead to both a sharp slowdown in economic activity as well as a drying of liquidity in the Treasury market, but only the latter seems likely to drive a Fed response. In fact, we heard explicitly from Powell and a number of his minions that a recession was quite possible and that if one arrives it will not deter them from their mission to drive inflation back to their target.

My point is that it feels there is a greater than warranted amount of optimism attached to expectations for today's number. That is evident by the recent rally in equity markets around the world, as well as the number of pundits who are suddenly enamored with the NY Fed's inflation expectation survey after its recent release showed both 1yr and 3yr expectations have fallen. On the way up, that particular survey was given short shrift by team transitory.

Ultimately, I would contend the key issue is not today's print, but where things settle over time. An interesting study was performed by well-known economist Joseph Brusuelas that showed the response function of the Unemployment Rate to various levels of inflation.

PCE Target	Projected Unemployment Rate	Job Losses (Millions)
4%	2.4%	-1.9
3%	4.6%	1.7
2%	6.7%	5.3
CPI Target	Projected Unemployment Rate	Job Losses (Millions)
4%	4.1%	0.9
3%	5.6%	3.5
2%	7.1%	6.0

Source: https://realeconomy.rsmus.com/how-high-must-unemployment-rise-to-tame-inflation/

Ask yourself this question, will Chairman Powell be willing to drive the Unemployment Rate up above 6.5% to achieve the Fed's 2% inflation target? While this is simply a study, and not necessarily a description of how things will actually turn out, you can be sure that the Fed has performed their own similar analyses and likely come up with pretty similar answers.

While measured inflation is certainly likely to decline somewhat going forward, I expect that it will plateau at some level that is higher than 2%, quite possibly in the 3.5%-4.0% range, and that one of two things will happen; the 2% target will be redefined higher, or the calculation of CPI/PCE will be changed so the numbers are lower. On the ground though, rising prices seem destined to be with us for a long time to come, regardless of what today's, or any future, CPI print shows.

But, leading into the data, let's look at the overnight session. Equity markets in Asia were pretty dull (Nikkei +0.25%, Hang Seng -0.2%, Shanghai 0.0%) while Europe has begun to edge higher over the past hour (DAX +0.5%, CAC +0.5%, FTSE 100 +0.3%) despite weaker than expected ZEW Survey data (-61.9 for German expectations, -60.7 for Eurozone expectations, with the German result the second lowest in the series history after December 1992). At the same time German CPI remained at 7.9% while UK Unemployment fell to 3.6%, its lowest level since 1973. It strikes me that the UK data will only encourage the BOE to continue aggressively hiking rates, as will the German CPI data. Explain to me again the bullish case. And, of course, it would not be complete without US futures higher, right now by about 0.6% across the board.

Treasury yields are falling this morning, down 4.2bps, as a combination of relatively attractive levels and the belief in sharply declining inflation has underpinned the market. European bonds, though, are a bit more mixed (Bunds +0.5bps, OATs -0.3bps, Gilts -0.7bps, BTPs -6.4bps) with the key Bund – BTP spread narrowing a touch on the day. We will see UK and European CPI data later this week, but there seems to be some anticipation that the ECB is going to be successful as well.

Oil (+1.1%) is higher again this morning as is NatGas (+1.1%) as there have been several well-reported calls for a soft landing in the US, rather than recession by major US banks. The key problem in the commodity markets, and really most markets these days, is that liquidity has been significantly shallower than we had become used to during the salad days of endless QE. This means that any movement can drive well beyond sensible due to a lack of players. Meanwhile, metals markets, too, are rocking with gold (+0.35%) the laggard compared to copper (+1.7%) and aluminum (+2.1%). If there is a soft landing then commodity prices ought to maintain their value.

Lastly, the dollar remains on its heels this morning, falling against all its G10 counterparts (SEK +0.65%, EUR +0.6%, JPY +0.6%) on purely position reductions and hopes that just like inflation, the peak has been seen. And there has been similar price action in the EMG space, led by ZAR (+0.7%) and HUF (+0.65%) as the broad bullish sentiment has traders and investors flocking out of dollars.

In addition to the CPI (exp 8.1% headline, 6.1% core) we already got the NFIB Small Business Optimism Index at a higher than expected 91.8 and then the Monthly Budget statement (-$217B) is due at 2:00pm this afternoon. It is important to remember that while headline CPI is slated to decline, the core number is actually looking at a higher reading than July's, so there are still plenty of price pressures around.

Equity markets continue to look for reasons to rally as they continue to dismiss the Fed's rhetoric. While 75bps is basically priced in for next week, there remains substantial optimism that we are very close to the end of the hiking cycle, although on what basis I am not sure. Regardless, any print with a 7 handle is likely to result in a sharp equity rally and to see the dollar decline further. An above consensus print seems likely only to leave things alone while we would need to see something well above last month's 8.5% to get the bears to control the narrative.

Good luck and stay safe
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