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SMBC Capital Markets, Inc.

fxPoetry

June 30, 2022

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Truly Passé

So, Christine and Andrew and Jay
Admitted, out loud, yesterday
The era of low
Inflation is so
Last decade, it's truly passé

When asked then, the next steps they'd take
In order, inflation, to slake
Christine was quite coy
But Jay will employ
Much higher rates, though things might break

On the final day of the ECB's summer gathering in Sintra, Portugal, we learned that, if nothing else, the heads of the Fed, ECB and BOE are not going to stop talking about how tough they will be on inflation. However, whether they actually will be that tough remains less clear. Chairman Powell was adamant that it was the Fed's primary focus and that they would rather act more boldly sooner, risking recession, in order to prevent those nasty inflation expectations from becoming entrenched. But perhaps his more interesting comments were a recognition that things may have truly changed. *"We've lived in that world where inflation was not a problem. I think we understand better **how little we understand about inflation**."* [emphasis added] In truth, this is amongst the most amazing things ever said by a Fed chair, admitting he doesn't really know how things work. On the one hand, perhaps this indicates the Fed will stop relying solely on their ineffective models as glimpses into the future. On the other, it promises to enhance financial market volatility as it implies their actions could change on a quarter (while that expression used to be 'on a dime' given inflation, I think it is time to be updated.)

Meanwhile, Madame Lagarde could not deny the changing landscape and how many of the secular disinflationary forces, notably globalization and just-on-time [sic] manufacturing are unlikely to maintain downward pressure on prices, but she continues to point to the Ukraine war as the key driver of inflationary outcomes in Europe as though a decade of negative interest rates from her institution had no bearing on the situation. And, while Powell clearly indicated that another 75bp rate hike was in the offing for the July meeting, Lagarde would not countenance more than 25bps at the ECB's next confab. Given her adamance on the issue, I am beginning to believe that the economic problems in Europe are far greater than currently assumed.

Finally, poor Governor Bailey remains in an untenable position given the ongoing exploding inflation story (CPI 9.1%, RPI 11.7%, PPI 15.7%) alongside the fact that growth is slowing rapidly. The BOE has already fallen further behind the curve than the Fed and is making a run at falling behind the ECB. This is evident in the fact that though the pound is little changed today, it has fallen more than 4% this month and more than 10% so far this year. Add to this the ongoing disruptions from the Brexit story, where the Johnson government seems focused on unwinding all of those negotiations, and Bailey really doesn't have a good option left. Despite the fact that interest rates in Europe are currently lower than in the UK, my sense is the pound will continue to underperform the single currency for the foreseeable future.

Are higher interest rates on their way? Certainly, that is true for the next few months, but by the end of summer, when the economic story is much more fragile, if not already recessionary, we will have to see if these three still have the same conviction.

Regardless of how the central banks behave in the future, a look at the here and now shows that investors remain increasingly uncomfortable holding risk assets. While US equity markets did very little yesterday overall, the selling resumed overnight as the Nikkei (-1.5%) and Hang Seng (-0.6%) both continued their trends lower although Shanghai (+1.1%) was able to bounce on the back of much higher-than-expected Chinese PMI data (Manufacturing 50.2, Non-manufacturing 54.7). It seems ending some of the Covid lockdowns was seen as a positive by the interviewees. Europe, however, has seen no respite with the DAX (-2.7%), CAC (-2.7%) and FTSE 100 (-1.9%) all sharply lower on the prospect of higher interest rates and slowing economic growth. Finally, US futures are all currently lower by at least -1.2%, not the most optimistic of beginnings.

In the bond market, yields are lower across the board as today, bonds seem like havens. Either that or investors are collectively pricing in a much slower growth story with recession overtaking inflation as the key concern. So, Treasury yields (-3.4bps) are edging back toward 3.0%, a key technical level, while Bunds (-9.9bps) and OATs (-8.7bps) are really in demand. In fact, the spread between bunds and BTPs (-5.4bps) is widening again, something Madame Lagarde truly fears for its potential 'fragmentation' impact.

Oil prices (-0.6%) are lower this morning after a sharp sell-off in yesterday's session following a report that gasoline inventories surprisingly grew last week. The good news is that perhaps it will cost a bit less to refill your car. The bad news is the implication is people are driving less due to economic concerns. Meanwhile NatGas continues its schizophrenic behavior with US (-0.5%) still reflecting that increase in supply given reduced LNG exports while Europe (+4.8%) is suffering from further stress based on Russia's actions and the lack of LNG imports! As an aside, Uranium (+1.1%) is rebounding after the IEA announced that nuclear needs to be part of every nation's plans going forward and countries should be looking to subsidize its construction. As economic harbingers go, copper (-1.6%) and aluminum (-0.4%) continue to point to economic weakness while gold (-0.4%) continues to fade into the background.

In the currency world, the dollar continues its steady march higher as the upshot from the Sintra meetings is that the Fed remains the most hawkish major central bank around. While the yen (+0.1%) is marginally higher this morning, yesterday it did print 137.00 for the first time since

September 1998. But the rest of the G10 space is under pressure today led by SEK (-0.9%) and NOK (-0.6%) with weaker commodity prices weighing there. Do not, though, ignore the euro (-0.4%) and now trading below 1.04 again with all eyes on the recent lows of 1.0350 seen in May and again in mid-June. I fear there is further to go here.

As to the EMG currencies, the dollar remains dominant here as well, with HUF (-1.0%), PLN (-0.8%) and RON (-0.5%) leading the way lower, following the euro with their usual high beta. But don't dismiss MXN (-0.45%) or the APAC currencies, most of which slid overnight as well amid the strong dollar mantra.

There is a raft of data this morning as follows:

Initial Claims	229K
Continuing Claims	1318K
Personal Income	0.5%
Personal Spending	0.4%
PCE Deflator	0.7% (6.4% Y/Y)
Core PCE	0.4% (4.8% Y/Y)
Chicago PMI	58.0

Source: Bloomberg

Given Powell's continued description of the US economy as strong, today's spending data may be just as important as the PCE data. But I can't see any print that would change the narrative at this stage. As such, hawkish Fed = stronger dollar remains the story in this space.

Good luck and stay safe
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