SMBC Capital Markets, Inc.

fxPoetry

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Continental Decay

In Europe, the story today
Shows growth now is fading away
The PMI data
From alpha to zeta
Described continental decay

As such it is not that surprising
That risk is so unappetizing
The dollar is strong
While stocks feel all wrong
And energy prices are rising

(Yes, I know that omega is the last letter of the Greek alphabet, please allow some poetic license here.)

Every day it becomes incrementally more difficult to find the bullish story for Europe. Whether it is the news that Russia has shut down NordStream 1 a second time for maintenance or comments from the Saudi oil minister that the disconnect between financial contracts and the physical market in oil may require a reduction in OPEC production, the continent can't seem to catch a break. Every day seems to bring another record high for next-day electricity prices in Germany (€650/MWh) or France (€615/MWh) and there is no end in sight to these rises. Every discussion seems to be about rationing of power and the anecdotes of companies closing down because they can no longer afford to operate with energy costs this high are growing.

Of course, the contrarian in me would say that this is exactly the time to be buying Europe, whether via equities or the currency itself, as every story seems designed to induce a bearish outlook. The problem with that thesis is to be contrarian for the sake of contrariness is not a good strategy. One needs to find the hidden gems within the underlying mess and take advantage of negative sentiment to acquire those. And in truth, it is very difficult to look over the current policy prescriptions and decide that things are going to get better in Europe anytime soon. You must have an extremely long timeline to see the value here.

It appears to me as though the market is still very much in the middle of pricing in the fact that Europe is destined for a very deep recession while inflation continues to rage. The ECB, which as discussed yesterday, is highly biased toward easy money, is going to find it exceptionally difficult to raise interest rates if growth is declining sharply and unemployment is rising. And based on the PMI data today, there is no indication that the trend of Eurozone growth is anything but lower. The implications here are that the euro, while it is making 20 year lows, seems likely to head lower still. In fact, as I explained yesterday, an eventual test of its historic low of 0.8230 cannot be ruled out at this time. Certainly, it will take some time to get there, but I would be selling on rallies if my exposures were long euros.

One of the key problems for the euro is that the Fed continues to sound quite hawkish, and I would argue that an increasing number of market participants are starting to believe that there won't be a pivot (to lower rates) but rather an extended pause at much higher rates in order to douse the inflationary fire. This view is evident in the change in Fed funds futures over the past 3 weeks. On August 1st, the futures market had priced the peak Fed funds rate at 3.27% in December 2022 and was pricing 58bps of rate cuts over the following 12 months. Today, the that same timeline shows Dec 2022 Fed funds at 3.61% with the Dec 2023 futures at 3.44%. In fact, the peak in today's market is not until March 2023 at 3.78%, so the Fed's message of a lot more hiking, and a period of pausing is beginning to get through to traders. But it strikes me if you listen to the actual words of the Fed speakers, the idea that Fed funds will start to come down in 2023 at all is unlikely. This is especially true if you are in the camp that inflation is going to remain much higher than target for a much longer time than seems anticipated by many in the market.

The point is, the dichotomy between a Fed that, as of now, continues to preen its hawkish feathers and an ECB that is under the extreme stress of rapidly rising prices and rapidly slowing growth could not be more stark. Given the ECB's inherent dovishness, expecting anything other than a token rate hike seems like wishful thinking. At this point, Europe is a continent whose basic premise, building stuff using cheap imported energy and exporting it to create excess surplus income, has been relegated to building much less stuff at a loss with incredibly expensive energy and running massive deficits. We need to see changes in the basics of Europe before we can consider buying "value" items there, including the currency.

These views became a bit clearer yesterday as US equity markets followed their European brethren and sold off quite sharply. Asia mostly followed suit overnight (Nikkei -1.2%, Hang Seng -0.8%, Shanghai 0.0%) although Europe, today, is mixed (DAX +0.1%, CAC 0.0%, FTSE 100 -0.3%) following the PMI data (French Composite 49.8, German Composite 47.6, Eurozone Composite 49.2, UK Composite 50.9). Ahead of that US PMI data, equity futures here are barely higher by about 0.1% at 7:00am.

While the Treasury market is little changed this morning, with the 10-year still above 3.0% at 3.015%, and the 2yr-10yr curve still inverted by 31bps, European sovereigns have seen a bit of a selloff (Bunds +0.7bps, OATs +0.9bps, Gilts +2.3bps, BTPs +2.4bps). This has widened the Bund -BTP spread to 233bps and continues to add pressure to the ECB and their Transmission Protection Instrument (aka buying BTPs and selling Bunds). While fear tends to drive investors toward the safety of fixed income, given the rapidly growing inflation pressures, the current yields do not offer very much safety and so it appears that investors in Europe are buying dollars to hold an asset that is appreciating.

Oil prices (+1.9%) continue to get whipsawed by headlines as yesterday saw a story about the imminence of an Iranian deal drive a 4% decline which was followed later by the Saudi oil minister's comments which allowed oil to recoup those losses. And remember, while ramping up production takes time and effort, for OPEC to cut back production is pretty easy and can be accomplished quite quickly. It suits OPEC to have higher prices and with US production hamstrung by the current administration's energy policies, OPEC remains in the driver's seat when it comes to the marginal price of oil.

Other commodities see NatGas (+1.9%) pushing up to $10/MMBtu, a level not seen since July 2008, but showing no signs of slowing down. Meanwhile, gold (+0.1%) has stopped falling for now as the dollar, while stronger, is only modestly so. Similarly, copper (+0.2%) and aluminum (+0.8%) are seeing modest gains today.

As to the dollar, NOK (+0.3%) is actually the leader in the G10 today on the back of oil's strength, followed by CAD (+0.25%) on the same story. On the downside, the euro (-0.2%) is the laggard although it has bounced off its recent low at 0.9901. However, that low will soon be taken out as well, at least in my view.

In the EMG bloc, IDR (+0.35%) is today's big winner after the central bank surprised one and all by raising rates 25bps overnight with no move expected. MXN (+0.3%) is benefitting from oil and after that its basically all red led by KRW (-0.45%) and HUF (-0.4%). The weakness in the won has authorities in Seoul quite concerned with the first real verbal intervention last night as the currency has fallen to 13-year lows. The forint, meanwhile, is suffering on the back of a growing cash deficit by the government and concerns of additional debt issuance.

Aside from the preliminary PMI data (exp 51.8 for Manufacturing and 49.8 for Services) we see Richmond Fed (-4) and New Home Sales (575K). Also, this morning we hear again from Neel Kashkari, the last speaker before the Jackson Hole Symposium begins on Thursday.

The dollar has rallied a long way in a short time, so a trading bounce seems quite likely. But nothing has changed the view that the dollar has further to rally.

Good luck and stay safe
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The views expressed are his own and may differ from Research.