SMBC Capital Markets, Inc.

# fxPoetry

July 28, 2022

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# Much Less Clear

Said Jay, for the rest of the year
Our guidance will be much less clear
That's mostly because
The time for a pause
May take many months to appear

Investors responded with glee
And went on a stock buying spree
But parsing Jay's words
The Fed-watching nerds
Explained that they all disagree

In this age where words no longer mean what they used to mean; it sometimes becomes difficult to understand what is going on. For instance, yesterday, after the Fed raised the Fed funds rate by 0.75%, as widely expected, and Chairman Powell explained that the Fed was "strongly committed" to bringing down the rate of inflation while "ongoing increases" in interest rates "will be appropriate", the market heard, "the Fed will stop raising rates soon and start cutting them afterwards to address the impending recession," or something like that. After all, it is extremely difficult for me to have heard Chairman Powell and come away with a dovish message. But then, I'm just an FX guy.

Arguably, the very best news from the Fed was that forward guidance is dead and buried, with decisions to be made on a meeting-by-meeting basis. You may recall that Madame Lagarde similarly ditched forward guidance two weeks ago. I have maintained that as a tool, forward guidance is only useful when lowering interest rates because no central bank wants to say, 'we are going to continue to raise interest rates for the foreseeable future.' The benefit of the meeting-by-meeting approach is that it will prevent excessive buildup in position sizing given the various opinions that exist on the economy and the Fed's reaction function. This means that while day-to-day movements in markets may be a bit choppier, we are less likely to see dramatic gap movements on surprising news. And gaps are what result in market problems.

In the end, I would contend that the Fed continues to be very afraid of causing a recession, or whatever they want to call it now, especially ahead of the midterm elections. However, inflation continues to be the number one concern of most Americans in every poll, and so Powell will continue to address it first. The Fed is happy to hang its hat on the most backward-looking indicator, the Unemployment Rate, which continues to hover near 60-year lows, as its excuse for raising rates further. And, while Powell did admit that there were sectors of the economy that were showing signs of weakness, he was adamant that the US is not in recession and that they would continue on this path if deemed appropriate. Keep in mind, however, the number of major companies that are announcing layoffs or hiring freezes. At least 30 have done so in the past two months, including Ford, Rivian, Tesla, CVS, Meta, Twitter and Netflix.

FWIW, which may not be very much, it remains very difficult for me to see how sharply negative real interest rates, which is still where we sit given the 2.5% Fed Funds rate and 9.1% CPI, or even 4.7% core PCE, are going to serve to reduce inflationary pressures. History has shown that real interest rates need to be positive, sometimes significantly so, in order to address inflation. Maybe the Fed will be able to drive inflation lower without causing a more significant recession, but history is not on their side. Another thing, do not be surprised if the Fedspeak that begins again next week sounds far more hawkish than Powell as I truly don't believe the Fed wants the stock market to rally, thus easing financial conditions. They want lower stock prices to help their cause, and if the market preempts the weakness, they may need to tighten that much more resulting in a sharper ultimate resolution on the downside.

Whatever they want to rename
Recession, in order to claim
That things are alright
They're in quite a plight
And likely to come in for blame

Which takes us to today's data release, the first look at Q2 GDP. Median analyst expectations are for a 0.5% print according to Bloomberg, while the Atlanta Fed's GDPNow forecast is currently sitting at -1.2%. Of course, the latter has been the genesis of the administration's efforts to change the definition of a recession given Q1 printed at a final -1.6%. So, the message from Powell, Yellen, President Biden and all of their media allies has been that focusing on two obscure data points is far too pedantic, and that a holistic view is required to accurately assess the economy. (My holistic view is that everything costs a lot more than it used to!) What is very clear is that if the BEA's print is negative, we will be inundated with yet another round of stories about how two consecutive quarters of negative real growth is not really a recession. But consider this, if the number is positive (and given the buildup in inventories, and reduced trade deficit, it well could be) especially if it is higher than that 0.5% estimate, it will allow the Fed to be that much more aggressive in their policy tightening, and that is likely a negative for risk assets. Just sayin'.

One last thing on the Fed, the balance sheet. Whither QT you may ask? While Powell explained that balance sheet reduction "is working fine" and "proceeding at [the] announced pace" the data seems to point otherwise. Of course, Powell also said that "when inflation changed direction in October, we were quick [to change as well]." That too seems a bit of a stretch given they continued QE for 9 more months and didn't begin to raise interest rates until 6 months after that change (which BTW was well after the trajectory of inflation changed.) The Balance Sheet data has not yet been released for this week, but to date, it has only been reduced by $16 billion over the first 7+ weeks of QT, far less than indicated.

Ok, after the huge post Powell rally, how have markets behaved elsewhere? Asia was not as enthusiastic with a mixed and moderate performance (Nikkei +0.4%, Hang Seng -0.2%, Shanghai +0.2%). Europe, too, has seen no follow-through at all with all three main indices lower by -0.1%, while US futures are in the red to the tune of -0.3% or so.

Treasury yields, which fell two basis points yesterday after the FOMC, are unchanged this morning with the 2yr-10yr inversion still sitting at 20 basis points. European bonds, though, are a touch softer with yields edging up (Bunds +2.1bps, OATs +1.4bps, Gilts +4.5bps) and that Bund-BTP spread, which widened significantly yesterday, remains above 230bps. Watch 250bps on that spread as the level at which the ECB starts to ~~care~~ get scared.

Oil prices continue to rebound, up 1.9% this morning, as euphoria in markets clearly implies more demand. NatGas (-1.5%) is softening on the back of less oppressive heat in the Northeast, while in Europe it is little changed on the day with no new news regarding the supply situation there. Gold (+0.35%) rallied sharply after the Fed yesterday and continues to hold its own, as does copper and aluminum, both higher by 1.3% this morning.

Finally, the dollar, which sold off on the idea that the Fed was not going to be as aggressive has regained a little of its footing this morning, especially against the euro, after all the Confidence indicators from the European Commission showed greater declines than expected. So, the euro (-0.7%) is leading the way lower in the G10 with one outlier (JPY +0.7%) as lower US yields result in a direct impact in the USDJPY exchange rate. If US yields continue to fall, look for USDJPY to continue to fall as well. In the emerging markets, it’s a tale of two time zones. In Asia, strength vs. the dollar was the order of the day, with KRW (+1.1%) and IDR (+0.5%) leading the way on a broad positive risk sentiment. But EEMEA (HUF -1.8%, CZK -1.0%, PLN -0.9%) are having a much tougher go of it on the euro’s weakness as well as ongoing concerns over the energy situation and economic activity there. And this was after the National Bank of Hungary raised its base rate by 100 basis points this morning.

Aside from the GDP data, Initial Claims (exp 250K) and Continuing Claims (1386K) are the only US data of note. But watch for German CPI (exp 7.4%) as well. With no Fed speakers scheduled, the FX markets are going to take their cues from both stocks and bonds. The last several times the stock market rallied on Powell’s post FOMC comments, it gave back those gains and then some within a week. I see no reason that this will be different. And so, I think the dollar continues to climb.

Good luck and stay safe
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