SMBC Capital Markets, Inc.

fxPoetry

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Recession is Nigh

T'was just yesterday when Christine
Was hawkish and sounded quite keen
To handle inflation
And, too, fragmentation
With rate hikes and new tools foreseen

But less than a full day has passed
And data seems now to forecast
Recession is nigh
So, her TPI
Will soon need prove it's not half-assed

The Transmission Protection Instrument (TPI) is a very clunky name for the ECB's latest ruse as to how they can continue to buy the bonds of weaker Eurozone nations while selling those of stronger nations in order to maintain the balance sheet at the same size. So, the first thing we know is that there is no effort at balance sheet reduction, aka QT. Instead, the ECB has put together a word salad that tries to define conditions for when this new tool could be used. Interestingly, on the surface, these conditions preclude the purchase of the bonds of pretty much all the PIGS nations, the ones that will need the help. However, Madame Lagarde clearly adheres to the Humpty Dumpty school of language; "When I use a word, it means just what I choose it to mean – neither more nor less."

In the end, what I believe the ECB was trying to accomplish was to create a tool so obviously powerful that the market would never dare test it and therefore it could stay on the shelf. After all, this was the Super Mario approach during the Eurozone crisis with the advent of the OMT (Outright Monetary Transactions) program, which was never utilized, but which was credited with reducing yields on the PIGS bonds by more than 200 basis points without negatively impacting the yields on Bunds. Alas, I fear investors do not hold Madame Lagarde in quite the same esteem as they did Super Mario, who after all, was a veteran central banker before being elevated to ECB President. Madame Lagarde's bona fides are more political in nature, and the market tends not to be as deferent to politicians.

Adding insult to injury, this morning's PMI data showed that the Eurozone has dipped into recession, or at least appears headed there quite soon. German (49.2 for both Mfg and Services, 48.0 Composite), French (49.6 Mfg, 52.1 Services, 50.6 Composite) and the Eurozone (49.6 Mfg, 50.6 Services 49.4 Composite) did not make for pleasant reading. Now, the ECB has made clear that in order to solve inflation they realize that recession is a possibility, and that was reiterated today by two speakers, Kazimir and Villeroy, but it strikes me that further policy tightening by the ECB will be much harder to achieve if GDP is falling.

And let's face it, raising their base rate to 0.00% can hardly be considered aggressive given that CPI is running at 8.6%, with the core rate at 3.7%. The ECB is well and truly bollixed.

So, how did markets behave? Well, after an initial pop in the euro on the surprise 50bp hike, which saw the single currency rise to about 1.0270, once Lagarde started to speak, it became clear that they did not have the wherewithal to solve the current mess. The euro slid back and chopped around the rest of the day. Now, this morning, after the weak data, the euro (-0.65%) has fallen further and while I had expected a test of the 1.04 level in the near future, that will only come about if US data falls so sharply that FOMC expectations change.

The other tell that the market is unimpressed is that the spread between Bunds and BTPs widened sharply after the introduction of the TPI and now sits at 230 basis points (it was 204 bps on Tuesday). Recent history has shown that above 250bps, the ECB starts to get quite agitated, so we may get to see some more ECB actions soon. Now, in the wake of the terrible PMI data today, bond yields across Europe have fallen sharply (Bunds -16.4bps, OATs -17.8bps, BTPs -18.0bps) and Gilts (-10.9bps) have also rallied although PMI data from the UK was far better than on the continent and actually beat expectations marginally.

Equity markets, which rallied in the US yesterday as yields fell sharply on weakening growth expectations, are generally slightly higher with Asia (Nikkei +0.4%, Hang Seng +0.2%, Shanghai 0.0%) and Europe (DAX +0.3%, CAC +0.3% FTSE 100 +0.3%) all benefitting from declining yields. I realize I failed to mention that Treasury yields, which tumbled 15bps yesterday are lower by another 6 this morning in the wake of rising Initial Claims data as well as a much worse than expected Philly Fed print. As to US futures, they are either side of unchanged at this hour.

Oil prices (-1.7%) are slipping on the recession narrative as are NatGas (-2.0%) prices, at least in the US, although in Europe and the UK they continue to soar (+5.4% and +7.9% respectively). Gold (+0.25%) had a wild day yesterday, first falling to new lows for the move at 1680 before rebounding sharply and now sits more than 1.5% above yesterday's opening levels. Copper (+1.1%) and aluminum (+0.75%) are both bouncing a bit today as well, although that is a bit surprising given the recession narrative.

Finally, the dollar continues to be the place where people want to be as it has rallied against the bulk of its G10 counterparts with SEK (-0.55%) and NOK (-0.5%) falling just slightly less than the euro. Confidence in European policy is under some duress these days. Meanwhile, it is no surprise that the CE4 currencies are suffering (HUF -0.9%, PLN -0.7%, CZK -0.7%) although ZAR (+0.75%) is still benefitting from yesterday's SARB surprise of a 75bp rate hike. Overall, we continue to see the dollar stronger vs. the bulk of the currencies around the world.

The only data today is the preliminary PMI data (exp Mfg 52.0, Services 52.7, Composite 52.4), all of which are a touch softer than June's data. However, given the weakness we continue to see in the regional Fed surveys, I suspect the risk is to a lower print here. The Fed continues to be incommunicado, and the futures market continues to price just 75bps into the curve for next week.

As I wrote above, I did expect to see further dollar weakness as positions were unwound, especially into the weekend, but perhaps traders are losing hope for a short-term dollar selloff and are preparing to test last week's 0.9950 lows. Longer term, until the Fed changes its tune, the dollar is still the premier currency. Meanwhile, USDJPY continues to track the 2yr Treasury yield quite closely, with yesterday's decline in yields matched by a decline in this cross. I see no reason for this theme to change either.

Good luck, good weekend and stay safe
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