SMBC Capital Markets, Inc.

fxPoetry

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Sensationalizing

Said Putin, reserves are on tap
And don't forget 'bout our Force Frappe
So, fears are now rising
Sensationalizing
The risk of a nuclear scrap

Meanwhile in DC, Chairman Jay
Will clearly have something to say
'Bout risk and reward
As he and his horde
Make policy later today

On this ~~Frabjous~~ Fed Day, Russian President Vladimir Putin stole the early headlines by announcing a partial mobilization of Russian reserves, up to 300,000 men, in order to bring reinforcements to his failing attack of the Ukraine. This is a larger number of troops than were used in the initial incursion, but it will take a little time for them to get into the field. And of course, there is the question of whether they will have enough materiel to effectively wage war. At the same time, he announced that he would hold referenda in four regions of Ukraine currently occupied by Russian troops, Donetsk, Luhansk, Kerson, and Zaporizhzhia, in order to determine if they want to become part of Russia or stay in Ukraine. (I wonder how those votes will go.) The idea seems to be to claim that now that they are part of Russia, he is within his rights to do whatever it takes to defend them against Ukrainian aggression. Speaking of which, he basically implied that the use of nuclear weapons would be considered if it was deemed necessary to protect Russia's territory. All in all, quite an aggressive plan by Putin, and one that must be taken quite seriously by Europe and NATO.

There are those who believe this is a sign of desperation on Putin's part because he has begun to realize that his gambit to recreate the Russian empire has failed and with it, likely his presidency. But he is a fighter, if nothing else, and will go down swinging.

The market response was relatively muted but on the whole, I would contend, mildly fearful. I base that on the fact that government bonds have rallied with yields retracing some of yesterday's gains (Treasuries -2.5bps, Bunds -4.5bps, OATs -4.0bps, BTPs -3.9bps). In fact, the only outlier here are Gilts (+1.3bps) which are responding to the leaked plans of new PM Truss with respect to her energy package (capping electricity and gas prices for the next six months at an estimated cost of £40 billion, as well as mooted tax cuts to help goose the economy's growth.) The combination means a lot more Gilt issuance so a selloff there is not that surprising.

However, the response has also been muted by the fact that at 2:00pm, the FOMC will release its latest policy move which will be followed by Powell's presser at 2:30. As of 6:45am, the Fed funds futures market continues to price just a 17% probability of a 100bp rate hike, leading most to believe that 75bps is the likely outcome. This will be the third consecutive hike of that magnitude, something that was unthinkable just six months ago. But given it is already priced into the market, the real mystery is what will the Dot plot look like and what about the economic forecasts.

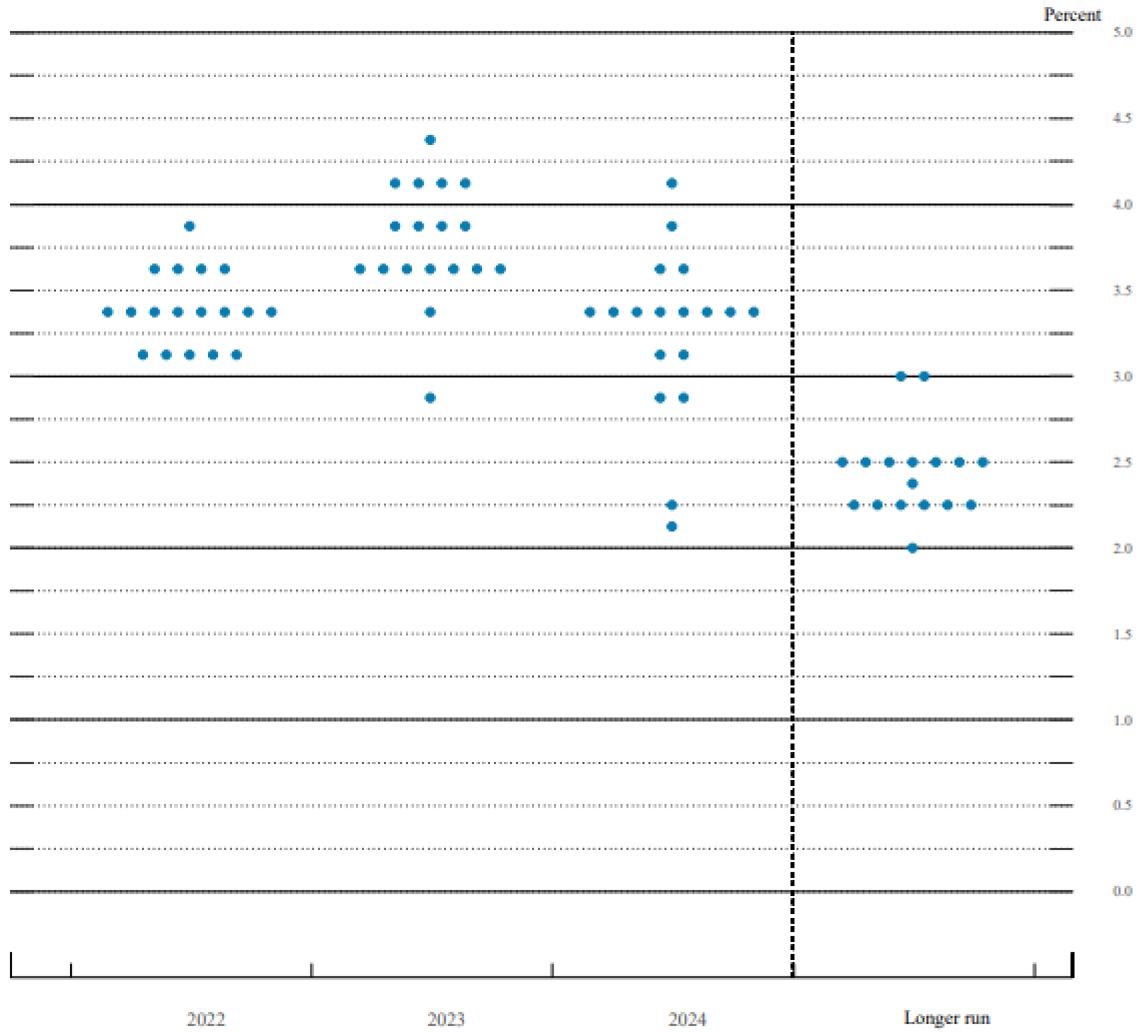
At this point, I feel it worthwhile to remind us all of the June forecasts by the Fed:

Variable	**2022**	**2023**	**2024**	**Longer Run**
GDP	1.7%	1.7%	1.9%	1.8%
Unemployment	3.7%	3.9%	4.1%	4.0%
PCE	5.2%	2.6%	2.2%	2.0%
Core PCE	4.3%	2.7%	2.3%	
Fed Funds	3.4%	3.8%	3.4%	2.5%

Source: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220615.pdf

Meanwhile, the dot plot looked like this:

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



The futures market is pricing a median 2023 Fed funds rate of 4.375%, about 50bps higher than the Fed was thinking back in June. And given the fact the Fed has ended forward guidance (have they though?) the dot plot is one of their key communication tools, along with the Summary of Economic Projections (SEP) listed in the table above. Arguably, the key question for markets is will they accept that expectation as appropriate, or will they push to see higher rates for even longer? It is on this issue that market reaction hinges.

Looking at other markets this morning, equities are edging higher in Europe (Dax 0.05, CAC +0.25%, FTSE 100 +0.75%) after a weak session in Asia (Nikkei -1.4%, Hang Seng -1.8%, Shanghai -0.2%). The UK market is obviously responding to the mooted tax cuts rather than the potential Russian aggression. US futures are basically flat as few are willing to act ahead of the Fed.

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The views expressed are his own and may differ from Research.

Meanwhile, energy prices have risen everywhere with oil (+2.7%) leading the way and NatGas (+2.6% in the US, +7.1% in Europe) responding to the pending escalation in Ukraine. This has also supported gold (+0.7%) and silver (+1.1%), although copper (-0.3%) and aluminum (-1.0%) are both suffering on recession fears from the same conflict.

Turning to the dollar, it remains king of the hill, rising against all its G10 brethren and most EMG currencies as well. SEK (-0.9%) continues to underperform as the market seems to hate the fact that the Riksbank was so aggressive yesterday in raising interest rates 100bps. The euro (-0.5%) is next as fears of Russia's aggression are clearly enhancing concerns over the euro's viability. Adding to the euro's woes is the election this weekend in Italy where a right-wing, populist, anti-EU coalition is mooted to win and form a government led by Giorgia Meloni, the leader of the Brothers of Italy. One of the interesting things about the recent overall movement has been the destruction of the idea that the Japanese yen represents a haven of any sort. It has been the worst performer YTD (-20.2%) while the Swiss franc has been the best, (-5.4%). The rationale for Swiss safety remains solidly intact, that for the yen, which was always shaky in my mind, has been shown to be wanting, at least for now.

Turning to the EMG bloc, HUF (-1.25%) is the worst performer, which seems to be suffering from the Russia news as it has been the biggest supporter of Putin throughout the conflict. After that, PHP (-0.9%) declined sharply on both the risk-off sentiment and a significant outflow from local equity markets, while PLN (-0.85%) is suffering from its proximity to the Russian escalation. But really, other than ZAR (+0.1%) which has managed to hold its own on the back of the rebound in gold and a CPI report that met expectations (7.6%), the rest of this bloc is down in some form or another, whether in APAC, EEMEA or LATAM.

There is one data point this morning, Existing Home Sales (exp 4.70M) but arguably we will be simply biding our time until the FOMC Statement and then the Chairman takes to the podium at 2:30. If pressed for my views I think the 75bps is a done deal, but that the market will listen to Powell and find whatever dovish word they can to try to force yet another equity rally along with a dollar decline. While that is likely to be short-lived, it could be somewhat violent.

PS, I neglected to mention the BOJ's meeting this evening where no changes to policy are expected. The risk there is that something comes across more hawkishly, perhaps an indication that YCC may end at some time in the future, and that USDJPY responds by falling pretty sharply. While I think that is a low probability, be aware.

Good luck and stay safe
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