SMBC Capital Markets, Inc.

fxPoetry

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Death Knell

As markets await Ms Lagarde
To play, from her hand, her next card
Signor Draghi's quitting
Has likely unwitting-
ly made her decision quite hard

If hawks rule the day and they hike
By fifty, the yield spread will spike
And then fragmentation
Along with inflation
Might come, both of which she'll dislike

Instead, if the doves win the day
And twenty-five's all that's in play
The euro could well
Hear its own death knell
As buyers get out of the way

One has to wonder just how much the market has priced in for today's activities. After all, ex ante, there is really no way to know what will occur. Arguably, if you are Christine Lagarde, the best news is already behind you as the NordStream 1 pipeline has been reopened and gas is flowing through at 40% of capacity, the same rate it had been flowing prior to the maintenance process, but still well below levels needed to allow Europe to top up reserves. This is made especially difficult by the heat wave currently impacting virtually all of Europe, and the resulting increase in the use of electricity. But at least the gas is flowing again after many fears it might not.

Alas for poor Christine, a much bigger problem has materialized, Super Mario has resigned again, and this time for real. Despite nominally winning votes of confidence in both houses of the Italian Parliament, the reality was that three key parties, 5-Star, Forza and Liga, all abstained and so it was clear he no longer had majority support. Thus, Italy is leaderless yet again, and the prospect of any action to help reduce potential financial or economic risk has been delayed until October at the earliest with mid-September elections now the likely next step.

Markets, however, are not about to wait around for Italy to figure out what it may or may not be able to do in September, and so traders and investors quickly sold their BTPs (+17.7bps) widening the spread vs. Bunds (+2.3bps) by more than 15 basis points and back to 227bps. We know that the ECB gets very uncomfortable about the fragmentation risk when that spread is above 200bps, so while they are meeting, I'm pretty sure this is a hot topic of conversation in Frankfurt.

The flip side of this issue is that with inflation running at 8.4% in the Eurozone and their base rate STILL AT -0.50%, a 25bp rate hike will very likely be seen as pathetically weak and the euro, which has rebounded over the past 3 sessions from a pretty oversold position, is likely to find itself under severe pressure once again. Now that parity has been broken, it no longer holds the same fascination for the market that it did before and is simply another waystation on the trip lower.

So, if you are Christine Lagarde, just what do you do? Attempting to fight inflation more aggressively by raising 50bps will serve to undermine any faith in Italy and likely force immediate implementation of the new "transmission protection mechanism", the euphemism for the ECB buying BTPs while selling Bunds as they seek to prevent the euro from fragmenting. It appears the mechanism will be to reinvest the proceeds of maturing Bunds (and OATs and Dutch government bonds) in the PEPP and APP programs into buying yet more BTPs. This will serve to underpin the weaker Italian debt while forcing the others to be subject to market variables as the price insensitive buyer abandons those markets.

Will it be enough to prevent things from getting worse? Initially it seems quite likely to be effective, but there is a lot of time between now and September 18, the mooted date of the Italian election, and therefore much can go wrong in the interim. This is especially so if the war in Ukraine takes an odd twist. Consider how President Putin might react if the American HIMAR missiles continue to wreak havoc on his armies' supply lines. Turning off the gas taps then might well be a response, and the negative impact on the Eurozone would be incalculable, with almost certain knock-on effects for Eurozone debt markets. The point is that regardless of what the ECB does today, much of their future activity will be driven by events far outside their control. And it is issues like this that tend to undermine a currency. Just sayin'.

After that story, really the only other news of note is that China has moved tanks onto the streets of Henan to protect the banks there after protests turned violent. It seems that several banks in the province were skimming money from their depositors for their own use and then locked those depositors out, preventing them from accessing their own deposits. When the depositors rose up in protest, the tanks rolled in. Now, it seems that President Xi has figured out this is a bad look, and so depositors in several of the affected banks, with up to CNY 100,000, will be repaid by the government. But as the property segment in China continues to slowly implode, you can be sure this won't be the last story of this nature. Again, over time, CNY (-0.15%) is likely to slide lower as a relief valve for a Chinese economy that is growing more slowly than in the past and whose key export markets are heading into, if not already having achieved, recession.

Ok, let's see how markets are behaving ahead of the ECB statement which comes at 8:15 this morning. In Asia, equities were mixed with the Nikkei (+0.4%) still taking its cues from the US, while the Hang Seng (-1.5%) and Shanghai (-1.0%) both slid, arguably on growing concerns over the entire situation in China. Europe is also mixed (DAX -0.3%, CAC +0.4%, FTSE 100 -0.5%)

and, not surprisingly, Italy (-1.3%) is the worst performer of the day. As I write at 7:00am, US futures are mixed although movement has been modest in both directions.

Treasury yields continue to edge higher, +1.1bps this morning, as the tension between inflation and recession continues to play out. The same thing is true across all of Europe with OATs (+2.1bps) and Gilts (+3.3bps) both somewhat softer today as well. While historically, a hawkish central bank is good for bonds, as investors tend to believe they will control inflation and potentially slow economic growth, until the first part of that equation is clear, the controlling inflation part, investors can be more circumspect.

Commodity prices have been the big loser today with energy leading the way lower in the wake of the restarting of NordStream 1. So, oil (-4.5%) and NatGas (-3.7% in the US, -5.8% in Europe) are both repricing future risks. Metals, too, are under pressure with gold (-0.8%) falling to its lowest level in more than a year as rising real interest rates take their toll on the barbarous relic. But copper (-1.8%) and zinc (-1.9%) are also stumbling although aluminum (+2.6%) seems to have a life of its own and is rebounding, likely on lower energy costs. Agricultural products are all lower as well, something we all welcome.

As to the dollar, it is broadly, though not universally stronger this morning. In the G10, NZD (-0.7%) is the laggard amid softer commodity prices, followed by JPY (-0.3%) which one would think would be a huge beneficiary of those falling commodities. But last night, the BOJ once again reiterated that there was to be no change in policy regardless of what else goes on around the world, and so the yen may well be about to embark on its next test of 140. Away from those, things are just less interesting with small movements in both directions. In the EMG bloc, THB (-0.7%) is the worst performer followed by HUF (-0.4%) while KRW (+0.4%) is the outstanding currency on the upside. The baht traded down to a 16-year low on concerns over slowing growth, especially as China continues to see slower growth prospects. Meanwhile, the won benefitted from a rising stock market and investment inflows. Again, the broad USD story remains a key background aspect here, but for right now, I expect other stories to dominate, at least up until the FOMC meeting next week.

On the data front we see Initial (exp 240K) and Continuing (1340K) Claims as well as the Philly Fed (0.8) and Leading Indicators (-0.6%). If pressed, I would say the Philly number would be the most important but given the ECB will have just issued their statement 15 minutes prior, I don't imagine it will garner much coverage.

For today, it is all about Lagarde and the ECB to see how she/they can square that circle. My gut tells me they will err on the side of dovishness as they are truly terrified of a blow-up of the Italian debt market, which is the 3rd largest in the world by debt outstanding. That implies that the euro will have trouble gaining ground, and likely the dollar will remain better bid.

Good luck and stay safe
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