SMBC Capital Markets, Inc.

fxPoetry

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A Pessimist's Voice

While soft is the landing of choice
And markets would clearly rejoice
The data of late
Has added more weight
To those with a pessimist's voice

This morning from Germany's ZEW
It's clear expectations are few
While Monday we read
From New York's own Fed
Reports future growth won't come through

We continue to see a disconnect between risk asset price behavior and data releases as the 'bad news is good' concept still seems to be driving things. This was evident yesterday in the US session when, after the Empire Manufacturing Survey printed at -31.3, its 4th lowest level in history (exceeded only by Covid in April 2020 and two months in 2009 during the GFC), equity markets around the world rose. The idea was that weaker data would simply ensure that the Fed, and by extension other central banks, would pivot to an easing stance by early next year and begin QE again to avoid recession. After all, that is what they have done consistently since 1987 when the Maestro himself, Alan Greenspan, cut rates and promised unlimited liquidity in the wake of Black Monday that October.

Then, this morning the German ZEW Survey results were released at -55.3, well below Covid levels and back down toward GFC readings from 2008. Meanwhile, the Eurozone readings actually hit all-time lows at -54.9, a harbinger of worse times to come across the continent. So, naturally, equity markets in Europe have rallied on the news (DAX +0.6%, CAC +0.3%, FTSE 100 +0.6%). It seems that the prospects of a recession have not dissuaded either investors nor their algorithms that weak data means monetary policy ease by respective central banks and therefore higher stock prices in the future.

However, it is clear that memories are short in financial markets these days, and lessons from history tend to be discarded rather quickly, especially if they are at odds with the latest narrative. In fairness, inflation hasn't been this high in 40 years, so it is not surprising that most market participants don't know how to deal with it. The issue, though, is that all the trading algorithms that dominate activity were built and tested on data that was gathered in a very different inflationary environment than currently exists. It was much easier for the Fed to pivot to easy money in 2018 or 2015 or 2011 or 2009 or…1987 when inflation was running at levels more consistent with price stability in the 2% range. But that is clearly not the situation today. Measured inflation in the US, no matter what metric you use, is at least 4.8% (Core PCE) and realistically somewhere between 6% and 8.5% (CPI). Central bank reaction functions are very likely to take this into account as they still consider inflation reduction as job #1.

In fact, we have heard a non-stop stream of Fed speakers in the past two weeks explain that raising rates to between 3.5% and 4.0% by the end of 2022 was appropriate and that continuing on from there in 2023 was likely as well. But markets don't believe them and so the pivot narrative is strong. Fed funds futures and the Eurodollar futures curve both are pricing short-term interest rates to peak at 3.6% in February 2023 and for the first rate cut to show up in July. The idea behind this is that when growth starts to demonstrably fall, the Fed will declare mission accomplished on inflation and ease policy to support economic growth. And maybe they will do just that. Maybe Jay Powell will be happy to be recalled as the second coming of Arthur Burns, the man who let inflation rip in the 1970's and allow the Fed to lose its last shred of credibility as a staunch supporter of prudent monetary policy. But I have become of the belief that is not the case.

While it speaks to just how little credibility the Fed has left on this topic, I think the message that the last dozen speakers have been giving has been too consistent to believe that the Fed's intention is anything other than what they are saying. They are going to continue to raise interest rates until they have achieved their goal of 2% inflation. If Powell is seeking to be reappointed in 4 years' time, he will need to have well and truly succeeded in this mission. And that should be enough time to demonstrate inflation is under control.

The implications of this disconnect between the Fed's stated intentions and market pricing are large and important. Essentially, we are very likely going to see a significant rerating of risk (read Stock market decline) and the current bear market rally will come to a sudden and very sharp end. In fact, if you look carefully, we are already beginning to see this. Consider the dollar, which having fallen for the past month has made a clear reversal and is once again demonstrating strength. For instance, today the greenback is stronger across the board. In the G10, NZD (-0.7%) is the laggard followed by the yen (-0.6%) and SEK (-0.6%). The story down under is that weaker Chinese growth and concern the RBNZ will not be hawkish enough tonight has traders offloading positions in kiwi. Meanwhile, the rest of the bloc is simply beholden to the idea that is growing in the FX markets, if not the equity markets, that the Fed is going to do what they say.

As to the EMG bloc, HUF (-1.9%) is once again the laggard as it continues to suffer from the credit outlook as well as concerns that the political standoff between Prime Minister Viktor Orban and the Brussels brigade over subsidies for Hungary will continue with no money coming soon. But the dollar's strength is evident throughout this bloc as well with the CE3 all softer by about -0.6% and weakness seen in KRW (-0.45%) on the weak Chinese data and MXN (-0.3%) as oil's price slides on recession worries.

Speaking of oil (-0.75%) it is lower again, although it has bounced off yesterday's lows amid growing supply concerns. As well, we have seen updated estimates of demand growth with needs for between 2mm and 3mm barrels per day additional oil now seen by most forecasts. The problem is it is not clear where this oil will come from given the dearth of exploration that we have seen over the past decade. Basically, much to the current administration's chagrin, US fracking is the world's best hope for future production growth. Elsewhere in the commodity space, NatGas (+3.5% in US, +7.7% in Europe) remains in high demand as Europe desperately tries to refill its storage tanks and much of that will be coming from US exports of LNG. Meanwhile, gold (-0.1%) is consolidating after a weak session yesterday on the back of the dollar's strength while copper (-0.2%) and aluminum (+2.1%) are mixed.

Finally, bond yields are edging higher this morning with Treasuries (+0.5bps) just a bit higher although European sovereigns (Bunds +2.0bps, OATs +2.4bps, Gilts +2.0bps, BTPs +7.8bps) are seeing more selling on top of a widening of the all-important Bund-BTP spread to 213bps.

On the data front, Housing Starts (exp 1527K) and Building Permits (1640K) lead us off this morning, with both of those readings forecast to be lower than June's data. Then a little later we get IP (0.3%) and Capacity Utilization (80.2%), although given the survey data from the New York Fed, that may seem a tad optimistic. On the Fed front, no speakers are scheduled which means the FX market will be looking for the total risk meme for clues. Currently, US futures are ever so slightly softer, and the day feels like it could become much more risk-off focused as it progresses. That implies the dollar has further to roam. Hedgers, keep that in mind.

Good luck and stay safe
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