SMBC Capital Markets, Inc.

fxPoetry

August 15, 2022

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Knuckle Under

Apparently things aren't great
In China, as it had a spate
Of terrible factors
That helped its detractors,
Most markets worldwide, to deflate

So, oil and copper and gold
And equities, all have been sold
One can't help but wonder
If bulls knuckle under
And alter the views that they hold

Tell me if you've heard this one before; a country's leadership feels threatened by circumstances beyond their control (say a virus) and react in a manner which, over time, is proven to be irrational (say, declaring policy to be the complete eradication of said virus) by restricting movement and economic activity nationwide. The result is that economic activity slows dramatically exacerbating an already problematic overleverage situation in the largest sector of the economy (maybe, property) and the central bank, which had been unwilling to ease monetary policy in order to prevent additional speculative activities, is forced to suddenly cut interest rates or watch the economy crater further. Add in the fact that the country's top leader is focused on achieving an unprecedented third term within the next two months and cannot afford to have the economy entering recession on his watch and you have the makings of a great Netflix show! Either that, or we have described the situation in China after last night's major monthly data output showed that things there are declining steadily and have been doing so since early 2021.

The other plotline in this feature is the ongoing activity in Taiwan where, in the wake of House Speaker Pelosi's visit two weeks ago, the President of Taiwan, Tsai Ing-wen, is set to receive a delegation of other US lawmakers, thus stirring that pot even further. As China claims Taiwan is a rogue province, but Taiwan sees themselves as an independent nation, that subject is one of ongoing angst for President Xi. However, in the current situation, Xi has put forward a very muscular response, potentially more for the home audience (after all, nothing brings a country together like a perceived foreign attack on its sovereignty) than as a deterrent to high profile visits of this nature. In fact, if one was cynical, it would not be impossible to believe that these visits and responses are all orchestrated by both sides in order to serve their domestic constituents rather than as a precursor to a hot war. Nobody could be that cynical, could they?

At any rate, the Chinese data showed IP slipping to 3.8%, Retail Sales falling -0.2% YTD, Fixed Asset Investment falling to 5.7% and Property Investment falling -6.4% YTD. Certainly, given the ongoing disaster that defines the Chinese property market, the last piece of data can be no surprise. Between strikes by the mortgage payers and the bankruptcies of a number of property firms, it is not clear who would consider buying property there right now. This is exacerbated by the ongoing lockdown potential for every single city in China.

With limited other news to drive markets, investors and traders have taken quite a negative view on things and risk assets, especially commodities, are under pressure while the dollar is flying.

Starting today with oil (-4.75%) it is getting hammered on the combination of the weak Chinese demand story alongside the news from Saudi Arabia that Aramco is prepared to increase production if requested by the Saudi government. That seems quite interesting as the Saudis just explained they have limited spare capacity, but maybe Aramco is seeing things differently. NatGas (-2.0% in US, +3.1% in Europe) is suffering here because of the break in the weather, but in Europe, concerns continue as to the availability of Russian gas going forward. On the energy front, it is worth mentioning that the Sichuan Province government in China just ordered industrial plants to shut down this week in order to ensure residential power supply. Again, the hits just keep on coming!

Metals markets, too, are under pressure with gold (-1.3%) and silver (-2.3%) both suffering from dollar strength while copper (-3.1%) and aluminum (-2.1%) respond to prospective weakness in Chinese economic activity. Even foodstuffs are falling, with all three big grains softer by more than 2% this morning.

Equity markets have had a bit of a different response with the Nikkei (+1.1%) the best performer globally after overnight GDP data indicated that growth has rebounded in Japan. But the Hang Seng (-0.7%) saw more selling pressure on the weak China story while Shanghai (0.0%) seemed to be caught between the weaker growth and the fact that the PBOC cut its 1yr Lending rate by 10bps in a surprise move. European bourses are basically unchanged this morning while US futures are pointing to a lower opening on the order of -0.3%.

Given the greater uncertainty worldwide, it should be no surprise that bond markets are a bit better bid with Treasuries edging lower by 0.4bps although the 2yr-10yr curve is back to its recent aggressively inverting ways and now back to -42bps. So much for the CPI induced steepener. In Europe, Bunds (-3.5ps), OATs (-2.9bps) and Gilts (-3.4bps) are all in demand as are virtually all European bonds. It is also worth noting that Chinese 10yr bonds saw yields fall 7.4bps after their rate move.

Finally, the dollar is king today, rallying against all counterparts both G10 or EMG. In the G10, NZD (-1.3%) and AUD (-1.2%) are the laggards as they are the most likely to be negatively impacted by a slowdown in China. NOK (-1.1%) is feeling the strain of oil's sharp decline as is CAD (-0.9%), but even the euro (-0.6%) and pound (-0.4%) are under pressure this morning as dollars are in demand.

Emerging markets are feeling the heat as well with HUF (-1.8%) suffering after S&P cut its credit outlook to negative while ZAR (-1.3%) is falling on the weakness across the entire commodity complex. PLN (-1.0%) and CZK (-1.0%) round out the largest movers although both these seem to be displaying their high beta to the euro.

On the data front, there is a fair amount to be seen including the Minutes of the last FOMC meeting:

Today	Empire Manufacturing	5.0
Tuesday	Housing Starts	1530K
	Building Permits	1650K
	IP	0.3%
	Capacity Utilization	80.2%
Wednesday	Retail Sales	0.1%
	-ex autos	0.0%
	Business Inventories	1.4%
	FOMC Minutes	
Thursday	Initial Claims	265K
	Continuing Claims	1450K
	Philly Fed	-5.0
	Existing Home Sales	4.89M
	Leading Indicators	-0.5%

Source: Bloomberg

In addition to the data, where Retail Sales will vie with the Minutes for most importance, we hear from three Fed speakers, Esther George, Neel Kashkari and Thomas Barkin, all three being regional presidents. (It's a funny thing, right after Powell repudiated forward guidance, we have heard a non-stop stream of forward guidance from most of the committee.)

The China news is significant as given the slowdown that is apparent in the US, and the even worse situation in Europe, if China is slowing more rapidly than expected, I don't think there will be too many concerns over the idea that three consecutive quarters of negative GDP growth is clearly a recession. But adding to that is the growth in geopolitical fears and the still aggressive tightening by the Fed and potentially both the BOE and ECB, and the prospects for financial markets going forward seem a bit less robust. I sense the dollar may have seen its bottom as the risk-on trade makes its way back into the lexicon. I also fear that we may have seen the final stages of the bear market rally that has driven markets for the past month. As Sergeant Esterhuas used to tell us on "Hill Street Blues", Be careful out there.

Good luck and stay safe
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