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fxPoetry

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# Animal Spirits Were Spurred

The G7 meeting revealed
That OPEC has no oilfield
Which can produce more
Like Biden's called for
Regardless of how he's appealed

Then last night from Beijing we heard
The travel curbs Xi had preferred
Would, after review,
Now be cut in two
Thus, animal spirits were spurred

I am old enough to remember when growing recession fears were driving oil prices lower in the market as numerous pundits around the world declared that the peak in inflation has been seen. But that was so last week! While recession fears still abound, and if anything, after yesterday's abysmal Dallas Fed reading (-17.7) and this morning's German GfK Confidence disaster (a new all-time low of -27.4), may even be growing, it turns out that G7 economic activity is not the only thing driving oil prices.

After all, supply is a critical input into that equation and what we learned yesterday from comments overheard between French President Macron and President Biden is that the UAE has zero spare capacity and that Saudi Arabia has, perhaps, 150K barrels per day of room to expand in the near-term. That is a far cry from what the G7, and the market, seemed to expect, thus adding pressure on everybody to figure out how to produce more oil. Of course, if we had simply looked at the fact that OPEC had changed their production 'quotas' to production 'targets', it would have been quite clear that they are maxed out. At this stage, on the supply side of the equation, the only marginal producer with potential capacity beyond Russia is the US shale patch. Alas, that remains anathema to this administration given its stated goals to end oil production in the US.

Meanwhile, on the demand side of the equation, last night's news from China was that they had zero recorded indigenous cases of Covid in either Shanghai or Beijing and would now be halving the travel quarantine restrictions that had been in place for the past many months. This implies that economic activity in China, which has been slowing dramatically due to the lockdowns, has the opportunity to resume growing. Adding to that were comments from PBOC President Yi Gang that the PBOC would continue to support the economy through abetting credit growth rather than reducing interest rates directly. Regardless of how they go about the process, the result is that further central bank support and less restrictive travel policies are going to increase oil demand in a global market that appears to be maxed out on the supply side.

The conclusion here is obvious, oil prices (+1.65%) have further to climb and that means that inflation seems unlikely to reverse course, at least in the near term. Remember, energy prices feed into the price of literally everything else, so if they continue higher, regardless of the short-term movements in interest rates, prices will climb. Now, given enough time and gumption, the central banks could certainly raise interest rates enough to crash economic activity and with it demand for energy, thus helping to push prices lower, but that seems like a pretty bad outcome as well. After all, do we really want a recession/depression? If it wasn't their own fault, one might feel sorry for central bank chiefs as they have no good answers to the current market questions. But more than a decade of easy money and effective debt monetization has consequences. Alas, we will all suffer them, not just those responsible for putting us in this position.

Investors, however, see the glass as half full this morning as risk assets continue to climb. In my view, this is a response to the fact that equity markets have been under intense pressure for the past 6 months and so a bounce is natural. When adding the ostensible positive Chinese economic news, that has been enough to get those animal spirits, at least in the equity markets, flowing again. To my eye, this remains a bear market rally that will soon run out of steam, just not today apparently.

So, Asian equity markets were all green (Nikkei +0.7%, Hang Seng +0.85%, Shanghai +0.9%) and the major bourses in Europe are even more ebullient (DAX +0.8%, CAC +1.25%, FTSE 100 +1.25%). It seems that despite more talk from ECB members that a 50bp hike in July is possible and more tightening is needed, the investment community is being soothed by Madame Lagarde who has promised that she has a plan to prevent fragmentation while simultaneously attacking inflation. Unfortunately, I feel that is highly unlikely as the first part of that problem can only be addressed by purchasing more BTPs and Spanish and Portuguese debt, while the second part requires the effective sale of government debt. And you thought Powell had a problem! Until any details of this alleged plan are revealed, the market will become increasingly skeptical any plan actually exists. And that will not be good for equity markets, nor the debt of the PIGS.

Oh yeah, US futures are currently higher by about 0.6% across the board, effectively unwinding yesterday's declines.

As to the bond market, yields are rising again, hardly the sign of relaxed inflation expectations. Treasury yields (+5.3bps) are once again climbing the least as Bunds (+10.9bps), OATs (+11.2bps) and Gilts (+8.7bps) are all selling off more aggressively. Interestingly, Italian BTPs (+7.0bps) and Spanish Bonos (+9.6bps) are outperforming Bunds thus the spread is narrowing slightly. At this point, despite my skepticism, bond investors seem willing to believe Lagarde has a plan.

Aside from oil's gains, one cannot be surprised that industrial metals (Cu +1.0%, al +0.5%) are rising as expectations of increased demand from China make their way into prices. Gold (0.0%)

is little changed and remains effectively sidelined as investors seem unwilling to get rid of it but are also not enthused about its prospects. However, if inflation expectations continue to rebound, look for gold to do the same.

Finally, the dollar seems to be finding support after its recent small pullback. The yen (-0.5%) continues to get decimated as the BOJ policy remains the global outlier and as of now, Kuroda-san refuses to countenance any idea other than QE and YCC are the right thing to do. While my view remains that a change in that policy will result in a stronger yen, there is certainly a possibility that depending on exactly how they execute the strategy change, the yen could fall much more sharply despite narrowing yield differentials. Markets are fickle things, so be wary. Away from the yen, kiwi (-0.35%) is the next worst performer although there is no specific news that seems to be driving it. In fact, overall, in the G10, today's movement away from the yen seems position related rather than fundamental.

Emerging market currencies see more losers than gainers led by INR (-0.5%), ZAR (-0.5%) and TRY (-0.5%). The rupee fell to a new record low after central bankers there discussed slowing their rate hiking cycle while the rand has suffered over concerns of even more power cuts following warnings by ESKOM, the national utility. On the plus side, THB (+0.6%) was the leading gainer on the Chinese reopening news, although gains beyond that were more limited.

Data this morning brings Case Shiller Home Prices (exp 21.15%) and Consumer Confidence (100.0) with the latter arguably more important than the former although neither is a major market mover. We also hear from SF President Daly, but my sense is given Powell will be speaking tomorrow, that will garner far more attention.

Is risk really on? As we head into month and quarter end, there is, ostensibly, a great deal of rebalancing to come regarding equity portfolios which means further stock buying. But once rebalanced, those portfolios will sit on the sidelines until September, so any further gains are likely to be short-lived in my view. Ultimately, energy prices remain the primary driver of all markets and activity, and as long as they are rising, I expect the dollar to continue to perform well on the back of continuing pressure higher in US yields.

Good luck and stay safe
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