SMBC Capital Markets, Inc.

fxPoetry

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More Havoc

Said Jay, 'don't know why you believe
That just because people perceive
Inflation is higher
That we would conspire
To raise rates, that's really naïve

Instead, interest rates will remain
At zero until we attain
The outcome we seek
Although that may wreak
More havoc than financial gain

"The economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved." So said Federal Reserve Chairman Jerome Powell at his Senate testimony yesterday morning. If that is not a clear enough statement that the Fed will not be adjusting policy, at least in a tightening direction, for years to come, I don't know what is. Essentially, after he said that, the growing fears that US monetary policy would be tightening soon quickly dissipated, and the early fears exhibited in the equity markets, where the NASDAQ fell almost 4% at its worst level, were largely reversed.

However, the much more frightening comment was the hubris he demonstrated regarding inflation, "*I really do not expect that we'll be in a situation where inflation rises to troubling levels. Inflation dynamics do change over time, but they don't change on a dime, and so* ***we don't really see how a burst of fiscal support or spending that doesn't last for many years would actually change those inflation dynamics***." [author's emphasis]. Perhaps he has forgotten the 2017 tax cut package or the $2.2 trillion CARES act or the $900 billion second stimulus package last December, but it certainly seems like we have been adding fiscal support for many years. And, of course, if the mooted $1.9 trillion stimulus bill passes through Congress, that would merely be adding fuel to the fire.

If one wanted an explanation for why government bond yields around the world are rising, one needs look no further than the attitude expressed by the Chairman. Bond investors clearly see the threat of rising prices as a much nearer term phenomenon than central bankers. The irony is that these rising prices are the accompaniment to a more robust recovery than had been anticipated by both markets and central bankers just months ago. In other words, this should be seen as good news. But the central banks fear that market moves in interest rates will actually work against their interests and have made clear they will fight those moves for a long time to come. We have heard this from the ECB, the BOE, the RBA and the RBNZ just in the past week. Oh yeah, the BOJ made clear that continued equity market purchases on their part will not be stopping either. History has shown that when inflation starts to percolate, it can rise extremely rapidly in a short period of time, even after central bank's change their policies. Ignoring this history has the potential to be quite problematic.

But for now, the central banks have been able to maintain their control over markets, and every one of them remains committed to keeping the monetary taps open regardless of the data. So, while the longest dated debt is likely to continue to see rising yields, as that is the point on the curve where central banks generally have the least impact, the fight between inflation hawks and central banks at the front of the curve is very likely to remain a win for the authorities, at least for now.

Turning our attention to today's session we see that while Asian equity markets were uniformly awful (Nikkei -1.6%, Hang Seng -3.0%, Shanghai -2.0%), part of the problem was the announcement of an increased stamp duty by the Hong Kong government, meaning the tax on share trading was going higher. Look for trading volumes to decrease a bit and prices to lag for a while. Europe, however, has shown a bit more optimism, with the DAX (+0.6%) benefitting from a slightly better than expected performance in Q4 2020, where GDP was revised higher to a 0.3% gain from the original 0.1% estimate. While Q1 2021 is going to be pretty lousy, forecast at -1.5% due to the lockdowns, Monday's IFO Survey showed growing confidence that things will get better soon. Meanwhile, the CAC (0.0%) and FTSE 100 (-0.1%) are not enjoying the same kind of performance, but they are certainly far better than what we saw in Asia. And finally, US futures are mixed as NASDAQ futures (-0.2%) continue to lag the other indices, both of which are flat at this time. Rising bond yields are really starting to impact the NASDAQ story.

Speaking of bonds, Treasury yields, after a modest reprieve yesterday, are once again selling off, with the 10-year seeing yields higher by 2.6bps. Similarly, Gilts (+2.6bps) are under pressure as inflation expectations rise in the UK given their strong effort in vaccinating the entire population. However, both Bunds and OATs are little changed this morning, as the ECB continues to show concern over rising yields, "closely monitoring" them which is code for they will expand purchases if yields rise too much.

On the commodity front, oil continues to rally, up a further 0.5%, and we are seeing a bit of a bid in precious metals as well (gold +0.2%). Base metals have been more mixed, although copper continues to soar, and the agricultural space remains well bid. Food costs more.

As to the dollar, mixed is a good description today with NZD (+0.7%) the leading gainer after some traders read the RBNZ comments as an indication less policy ease was needed. As well, NOK (+0.5) is benefitting from oil's ongoing rally, with CAD (+0.25%) a lesser beneficiary. On the flip side, JPY (-0.5%) is the laggard, as carry trades using the yen as funding currency are gaining adherents again. I would be remiss if I did not mention the pound (+0.2%), for its 13th trading gain in the past 15 sessions, during which it has risen over 4.3%.

In the EMG bloc, it is the commodity currencies that are leading the way higher with RUB (+1.2%) on the back of oil's strength on top of the list, followed by CLP (+0.7%) on copper's continued rally, MXN (+0.7%), oil related, and ZAR (+0.5%) on general commodity strength. The only notable loser today is TRY (-0.8%), after comments by President Erdogan that Turkey is determined to reduce inflation and cut interest rates.

On the data front, New Home Sales (exp 856K) is the only release, although we hear from Chairman Powell again, as well as vice-Chairman Clarida. Powell's testimony to the House is unlikely to bring anything new and he will simply reiterate that their job is not done, and they will maintain current policy for a long time to come.

It seems to me that the dollar is trapped in its recent trading range and will need a significant catalyst to change opinions. If the US yield curve continues to steepen, which seems likely, and that results in equity markets repricing to some extent, I think the dollar could retest the top of its recent range. However, as long as the equity narrative continues to play out, that the Fed will prevent any sharp declines and the front end of the yield curve will stay put for years to come, I think an eventual break down in the dollar is likely. That will be accelerated as inflation data starts to print higher, but that remains a few months away. So, range trading it is for now.

Good luck and stay safe
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