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Wanton Neglect

While prices keep rising unchecked
And central banks roundly reject
Inflation's their fault
It's clear the gestalt
Now highlights their wanton neglect

But now they've another concern
And that is recession's return
The data of late
Is clearly not great
At what point will, rate hikes, they spurn

A funny thing has happened to investor sentiment, or at least is beginning to happen, and that is the concerns over inflation are starting to evolve into concerns over slowing growth. You may recall last month when the first look at Q1 GDP was released at a MUCH worse than expected -1.4% and the Fed, as well as many pundits, were quick to highlight that the number was not nearly as bad as the print suggested due to changes in inventories and the impact of supply chain snafus reducing imports. Street forecasts for GDP growth this year remain strongly positive with the IMF, for instance, calling for 3.6% real GDP growth in 2022. And yet…

Yesterday we saw our third regional Fed indicator in the past two weeks and all of them were substantially below expectations with two of them, Empire Mfg at -11.6 and Richmond Fed at -9, falling into negative territory. Philly Fed, at 2.6, was relatively robust! The problem with these outturns is that negative numbers in this type of diffusion index imply things are really getting worse as more respondents see slowing activity than any acceleration. There are two more regional surveys coming in the next week, Kansas City and Dallas, so perhaps this is just an East Coast disease, and those regions are better off. But when we look at the PMI data, which was also softer than expected, as well as Leading Indicators, which were negative in April, it appears that a pattern is beginning to form. And this is not the type of pattern that any government likes to see.

The author is a salesperson in SMBC Capital Markets, Inc.
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Granted, Chairman Jay did explain that there would be some pain as they fight inflation, and that he expected to see the Unemployment rate rise a few ticks in order to achieve their goal of stanching rising prices. But I'm pretty sure the Fed did not expect the slowdown to occur before they even started QT or barely got going on raising interest rates. Remember, too, that a key part of the Keynesian thesis on which the Fed relies is that by slowing demand, they will reduce price pressures and therefore inflation will ease. Alas, the combination of events over the past two years with the Covid shutdowns and now the Ukraine war has resulted in severe breakages of supply chains. When these issues are added to the chronic underinvestment for replacement of energy sources, at least ones that work at all times, it can be no surprise that prices in things like food and energy are continuing to rise. The price elasticity of both food and energy is extremely low, meaning that regardless of the price, people will still pay for them as they are necessary for life. It will take a very significant amount of demand destruction to alter these price trajectories, and I'm guessing neither Powell nor Lagarde, nor any central bank head, is prepared to drive their economy into a deep depression just to break inflation.

What does this mean? Well, as I have frequently pointed out before, my expectation was that long before inflation was tamed the Fed would blink as growth would begin to slow. And though recent surveys show that inflation is the number one issue on voters' minds everywhere, I anticipate that will soon turn to the economy in general as activity slows. We have already heard of numerous companies reducing their workforces as activity has slowed dramatically, with companies like Ford, Noom and Robinhood all going through the process just last month. We have also read of how Amazon is reducing its warehousing space as it is simply not needed at this time. We saw much weaker earnings and forecasts from Walmart and Target, the leading discount retailers and, of course, we have the flashing red lights of equity market declines indicating that there is real concern about the economy at this time.

With this as background, it will be increasingly difficult for the Fed, or any central bank, to aggressively raise interest rates. The futures market is already starting to back off its expectations with less than 8 hikes (200 basis points) priced in for the next nine months, from more than 225 at one point. As long as this new zeitgeist continues, the dollar will have increasing difficulty continuing on its journey higher. Of course, if the economic slowdown is widespread, (we are even seeing large cuts in forecasts for China's GDP to 4.5%), no central bank is going to tighten aggressively. Though FX is a relative game, given the dollar's strong move higher over the past year plus and the inbuilt expectations that the Fed was going to be the most hawkish bank around, if the Fed reverses course, even if the ECB never raises rates, the implications are the dollar has a long way to fall. While today's FOMC Minutes will not tell us if the Fed is about to blink, I expect that we will have a pretty good idea by the time they next meet in three weeks' time.

Ok, what did we learn overnight? Equities in Asia were mixed (Nikkei -0.25%, Hang Seng +0.3%, shanghai +1.2%) although they are a tiny bit higher in Europe (DAX +0.1%, CAC +0.1%, FTSE 100 +0.4%). US futures, though, have given up early session gains and are softer by about -0.5% at this hour.

Bond markets are definitely starting to feel like they have seen the peak in yields with rallies across the board again this morning and yields sliding. Treasuries (-2.0bps) are actually far less ambitious than Bunds (-4.3bps) or OATs (-4.5bps) although Gilts (-1.9bps) are more like Treasuries. As to the shape of the curve, it is flattening slightly, but remains far from an inversion. That story is old news.

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Oil prices (+1.1%) continue to trade in their recent range and are awaiting the next catalyst of note. A European embargo on Russian oil is likely to result in a breakout to the high side, above $115/bbl, while any movement toward an end to the Ukraine war will see the opposite result. My money is on the former before the latter. NatGas (+0.9%) continues to perform extremely well and has, IMHO, much further to rise. Gold (-0.6%) is suffering amid a broadly stronger dollar this morning but we are seeing weakness across the entire metals complex with copper (-1.8%) and aluminum (-1.65%) both under pressure. Certainly, these are potential harbingers of that slowing growth story.

And the dollar is back as king today, rising against all its G10 peers with SEK (-1.1%) the laggard and then AUD (-0.65%) and EUR (-0.6%) next in line. In Sweden, it seems that consumer confidence is under pressure with the latest reading falling to its lowest level since 1995 during the Swedish banking crisis. Meanwhile Aussie is suffering on the metals declines and the euro is feeling pressure as ECB doves have been more vocal today than hawks. In the EMG bloc, the CE4 are all following the euro lower led by HUF (-1.9%) and PLN (-1.1%) while TRTY (-1.3%) continues its steady decline to oblivion. But the list of losers here is long with only a few APAC currencies showing any life and those gains down to 0.2% or less, hardly enough to discuss.

On the data front, Mortgage Applications (-1.2%) fell for the 13th time in the past 16 weeks, not the sign of a strong housing market, which given rising mortgage rates can not be surprising. At 8:30 we get Durable Goods (exp 0.6%, 0.6% ex transport) and then at 2:00pm come the FOMC Minutes. Vice-Chair Brainerd speaks at 12:15pm, but it is a commencement speech, so seems an unlikely venue for policy comments.

At this point, the only question is when will the Fed blink. For now, it is not clear, and while the dollar's gains have slowed down, there is still a reasonable chance the Fed will continue tightening policy into this economic slowdown. I have been very clear that as long as they remain hawkish, the dollar will remain bid, however, once they hint the end of tightening is nigh, look out below for the buck.

Good luck and stay safe
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