SMBC Capital Markets, Inc.

fxPoetry

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Andrew Fately
Executive Director, Senior FX Marketer
Global Markets Marketing Department
andrew_fately@smbcgroup.com
Direct: +1 212-224-4532
Representative: SMBC Capital Markets, Inc.

More Problems Ahead

The bank that's on Threadneedle Street
Is set for its members to meet
The question on lips
Is twenty-five bips?
Or fifty, a hike bittersweet

As bad as things are for the Fed
In London, Sir Bailey's misread
The clues about prices
Creating a crisis
With many more problems ahead

As the market looks ahead to tomorrow's payroll data from the US, it is somewhat diverted by today's BOE meeting where interest rate traders are pricing a 78% chance of a 50 basis point hike taking the base rate up to 1.75%. It is ironic that the BOE was the first of the G10 countries to raise rates last year, seemingly recognizing that inflation pressures were building quickly and that something needed to be done, yet at this point, after aggressive actions by virtually every other nation (Japan excepted), the UK is the furthest behind the curve. Consider that even if they do raise rates by 0.50%, with CPI at 9.4%, and RPI (an older version of price measurement in the UK with a very long history) at 11.8%, real interest rates will still be staggeringly negative.

You may ask, why would the BOE even consider a 25bp rate hike given the inflation situation? And the answer is that unlike in the US, where fixed mortgage rates are the norm, throughout the UK (and Europe too), mortgage rates tend to be variable. This means if the BOE raises rates, homeowners across the country see higher mortgage bills almost immediately. Given the problems they are already having with the dramatic rise in energy prices there, the pain will be excruciating, not something any politician wants to consider. Ironically, the BOE has a single mandate, "to deliver price stability and, **subject to that**, to support the Government's economic objectives including those for growth and employment". However, this is merely another indication that the idea of independence and central banking is nothing more than a myth fostered by governments to, ostensibly, keep their hands clean when the central bank does things that are unpleasant politically. Central bank independence was a great theory with no basis in reality. If pressed, my money is on 50bps, but we shall see. Given market pricing, I would contend that the risk to the pound is asymmetrically lower, as 25bps will undermine Sterling, while 50bps will do little more than is already assumed.

It's possible there's never been
A comment to cause more chagrin
Than Daly's refrain
She doesn't feel pain
From prices, as higher they spin

"*You know I have to say that I live … I don't feel the pain of inflation anymore. I see prices rising, but I have enough that I can make substitutions, that I can do things. So, I'm not immune to gas prices rising, food prices rising. I sometimes balk at the price of things. But I don't find myself in a space where I have to make tradeoffs, because I have enough, and many, many Americans have enough."* - SF Federal Reserve Bank President Mary Daly, August 3, 2022

If you are reading this note, my guess is the current raging inflation has not forced you to choose between paying the rent and eating dinner, although both costs have almost certainly risen sharply. However, it is unambiguous that the vast majority of the population in the United States have clearly felt the pain of higher prices, most specifically at the gas pump and the grocery store, but generally in everything you do. And while we all may be thankful that we are in a position to withstand these pressures, it is unlikely to be something we flaunt, rather it is something for which we are grateful. Thus, for the president of a regional Federal Reserve bank to utter these words is extraordinary. Tone-deaf doesn't begin to describe the nature of these comments. And the key problem is that her policy choices are clearly going to take this attitude into account. They cannot help but do so. This implies that Ms Daly seems likely to come down on the side of allowing higher inflation in the long run. After all, for her, it's not painful.

Chairman Powell has been explicit that high inflation is a major long-term problem and that the Fed is committed to reversing its course. Yesterday we heard from four other Fed members, besides Daly, and each continues to highlight how important reducing inflation is for the country. But do they really believe that? Daly's comments certainly call that into question, as each of them is in the same place financially, if not more secure. Right now, the equity markets are 'fighting the Fed' breaking the cardinal rule of investing. The Treasury curve inversion has equity investors convinced the Fed is not going to raise rates very far regardless of how inflation plays out. They may well be correct, but if so, the result is that the idea of 2% inflation as a target will die. Watch for comments about how 4% or 5% inflation is really not that big a problem and you will know the future is here.

**** BOE raises Base Rate 0.50% to 1.75%****

Ok, so 50bps it was. The FX response was for the pound to sell off about 0.6% on the news, and in fact, the dollar is slightly better bid. Meanwhile, the UK Gilt curve has inverted for the first time since 2019. It seems recession is coming everywhere.

Let's take a trip around markets now. Yesterday's US equity rally was followed in Asia across the board (Nikkei +0.7%, Hang Seng +2.1%, Shanghai +0.8%) and Europe, too, has decided that things are great, with the major indices there pushing higher in the past couple of hours (DAX

+1.3%, CAC +1.0%, FTSE 100 +0.3%). Not to worry, US futures remain buoyant as well, up about 0.25% at this hour.

Bond markets are mixed with Treasury yields higher (+1.8bps), taking back yesterday's small losses, but European sovereigns all seeing yields fall (Bunds -3.1bps, OATs -4.5bps, Gilts -4.1bps, BTPs -3.5bps). If I didn't know better, I would say that investors are gaining belief that the ECB and BOE are going to be effective at fighting inflation. I'm not sure why they would believe that, but that's what the pricing indicates.

Oil prices (+0.5%) are rebounding slightly after a sharp decline yesterday on the back of the EIA's stockpile report showing a surprising build in inventories. Adding this to the modest 100K bbl/day increase in OPEC+ supply was enough to drive a selloff. I have no doubt that a recession will have some impact on oil demand and reduce prices temporarily, but consider, too, that given the NatGas situation in Europe, there has been a huge move by German companies, especially, to convert their gas burning boilers to oil and diesel. That will significantly increase demand all by itself. And none of this has addressed structural supply shortages that will play out increasingly over the coming years. Elsewhere in the commodity space, gold (+1.0%) and silver (+1.3%) are rebounding nicely, both well above their recent lows as they seem to be catching an inflation bid. However, copper (-0.35%) and aluminum (-0.3%) are both concerned over recession.

As to the dollar, it is generally softer, although not as much as it was before. NZD (+0.7%) is the G10 leader as it continues to benefit from the better risk tone overall. AUD (+0.45%) and SEK (+0.45%) are both in accord there while on the downside, JPY (-0.25%) is slipping on a combination of the wider spread between US and Japanese yields and the lack of a need for a haven, while GBP (-0.3%) is now down on the day after the BOE outcome.

EMG currencies saw a mixed picture with INR (-0.4%) the worst performer after a worse than expected trade balance was reported, while THB (+0.7%) has benefitted from improved risk sentiment. There are more gainers than losers in the space, but besides those two, the movements have been quite small.

On the data docket this morning we have the Trade Balance (exp -$80.0B) and Initial (260K) and Continuing (1383K) Claims. Yesterday's ISM data was better than expected as were Factory Orders, just further ammunition for the Fed to continue to be aggressive. We also hear from Ms Mester again at noon.

At this point, it appears the market doesn't believe the Fed will continue to raise interest rates to rein in inflation. Not only is the Treasury curve at its steepest inversion since 2000, but the Fed funds futures curve is pricing in rate cuts for early next year. However, the Fed's rhetoric continues to be for higher rates, with Fed funds at 4.0% a real possibility by year end. equity rallies and the Treasury inversion actually ease financial conditions and the Fed is trying to tighten those. I fear there will be a comeuppance of significance as the year progresses. I would look for much more hawkish commentary from Powell at Jackson Hole at the end of the month, and I think that 75 is clearly on the table for September. The market is not yet pricing that in, so keep that in mind.

Good luck and stay safe
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The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.