SMBC Capital Markets, Inc.

fxPoetry

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A Fool's Paradise

The Saudis have said they'll increase
Production lest Russia does cease
The war in Ukraine
So Poland and Spain
Have petrol until there is peace

The welcome result is the price
Of oil has dropped in a trice
But have they enough
Of that sticky stuff
Or is this a fool's paradise?

The news overnight that Saudi Arabia is going to increase oil output in order to make up for lost production by Russia had an immediate impact on the market with the oil price falling about 2.5%. And while that is certainly welcome, it is hardly sufficient to offset what we have been living through over the past two plus years. Since April 2020, WTI has risen more than tenfold (1070% to be exact) and was trending higher long before Vladimir Putin invaded Ukraine. Even if we consider the price gains from the pre-Covid peak in October 2018, when the US economy was performing well enough so that the Fed was tightening monetary policy, the price of oil has increased by 53%. The point is the longer-term trend in the price of oil remains higher and short-term acts are unlikely to change that situation.

Remember, for the past decade, under the guise of ESG investment principals, there has been a systematic reduction in efforts to explore for new sources of oil and natural gas. The idea that fossil fuels would be replaced by renewables such as solar and wind power were widespread but have proven to be unworkable due to the inconsistent nature of the renewable energy sources. Alas, we are now living through that transition with insufficient power production for the world's needs. In the end, this means that the price of conventional power sources, like oil and natural gas, are likely to continue to rise for many years into the future as production starts to dwindle while demand continues to increase. I fear it is unlikely that we ever see $2.00/gallon gasoline again. In fact, at this point, wouldn't we all be thrilled with $3.50?

The next place attention will turn
Is payrolls where we hope to learn
If growth is apace
And so we must brace
For hikes for which hawks clearly yearn

And lastly, next week's ECB
Confab ought be something to see
They keep talking tough
But act the cream puff
As they have not yet killed QE

Having moved past the oil story overnight, which has helped risk sentiment overall, the market will next turn its attention to Friday's Payroll report. Remember, a key premise of the hawkish Fed is the very strong economy that currently exists here in the US. On one hand, there has been some data lately that supports that idea, although I would contend most of that data is backward looking rather than forward focused.

For instance, just this week we saw a very strong Chicago PMI print (60.3), as well as a much better than expected Consumer Confidence print (106.4), albeit the latter was still a decline from April's reading. Yesterday's ISM data was stronger than expected, although it had some weaker subindex readings, notably the employment piece fell below 50 for the first time since late 2020. But, too, there have been some weak data points as well, notably Durable Goods and the reduction in the Q1 GDP estimate. As well, the Citi Economic Surprise Index, which tracks actual data vs. its estimates has fallen to its lowest level since the Delta wave of Covid hit in Sep 2021 and is deeply negative. That is not a strong growth signal.

Remember, too, that Employment is a backward-looking indicator as companies tend to be slow to fire as well as hire given the expense involved in the hiring process. So, it is not uncommon for the unemployment situation to look good while a recession is already beginning. I can't leave this topic without mentioning two other tidbits of info, both comments by well-known individuals. First, JPMorgan CEO Jamie Dimon exclaimed that the gathering clouds on the economic horizon were a "hurricane" and that JP would be husbanding its balance sheet resources to weather this storm. Next we heard from former NY Fed President Bill Dudley, who clearly told us the Fed was setting out to engineer a recession in order to slay the inflation dragon, and that it was the only thing on which Powell and friends were focused.

If that is not enough heartfelt warmth, a quick look across the pond sees that the ECB meets one week from today and all are awaiting to see just how hawkish they will pretend to be. Just this morning we heard from Governing Council member Francois Villeroy de Galhau that inflation was too strong and the ECB just pare stimulus. We have heard that from a number of the more hawkish members consistently for the past month. But we have also heard from the doves explaining they cannot move too quickly. And it is important to note that despite all the rhetoric, THE ECB IS STILL BUYING ASSETS IN THEIR QE PROGRAM AND WILL DO SO UNTIL THE END OF THE MONTH. This is hardly the action of a hawkish central bank. I'm sure they will raise interest rates in July, but after that, much will depend on just how poorly the Eurozone economy is performing. While inflation is raging in Europe as well, tightening into a recession is a tough call, and one it is not clear Madame Lagarde is up to making.

OK, really quickly, let's look at markets. While overnight equity markets were mixed (Nikkei -0.15%, Hang Seng -1.0%, Shanghai +0.4%) Europe has had a better go on the lower oil prices (DAX +0.8%, CAC +1.1%). The UK is celebrating the Queen's Platinum Jubilee so markets there are closed today. US futures are higher by about 0.5% after two consecutive modestly weak sessions.

Bond market activity shows more selling pressure than anything else, although Treasury prices are little changed this morning. However, in Europe, yields are clearly higher with Bunds (+1.6bps and right at 1.12% again) and OATs (+1.8bps) falling while the rest of the continent is seeing even larger price declines (higher yields).

Aside from oil's decline, NatGas (+1.1%) is demonstrating why it is the most volatile trading product out there. Gold (+0.6%) once again found support well above $1800/oz and continues to consolidate, while copper (+3.25%) is benefitting from both short-covering as well as some optimism that as China reopens, demand will pick back up. However, aluminum (-2.2%) is feeling pressure from some questions about inventories in China and whether they all exist or not.

After a strong session yesterday, the dollar is giving back some of those gains and is softer vs. all its G10 brethren with the pound (+0.5%) leading the way although on what basis is not clear. But the gains have been broad based as the dollar is suffering everywhere today. Perhaps the most surprising move, or lack thereof, is of CAD (+0.1%) which despite a 50bp rate hike by the BOC yesterday and a hawkish accompanying statement, has not seen much traction. In the EMG bloc, the outliers are KRW (-1.2%) which fell sharply after comments from the FinMin that inflation was set to remain quite high there, around 5%, for a while to come. PHP (-0.6%) was also under pressure after the market triggered stop-loss orders when the exchange rate traded to a key technical support level.

Today brings a bunch more data starting with ADP Employment (exp 300K) then Initial (210K) and Continuing (1340K) Claims and finally Factory Orders (0.7%) at 10:00. We also hear from Cleveland Fed President Mester early this afternoon, as the Fed approaches its quiet period starting tomorrow.

Nothing has changed in the markets to my reading as the Saudi oil news is likely to have only a short-term impact on things and the main drivers, inflation and central bank responses, seem well telegraphed for now. While it remains to be seen if they will have the stomach to continue to tighten policy if growth is slowing, the market is clearly expecting they do. As long as that is the case, and the Fed is perceived to be the leader, the dollar should continue to regain its footing. But woe betide those long the dollar if (when) the Fed blinks.

Good luck and stay safe
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