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SMBC Capital Markets, Inc.

fxPoetry

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# Deep Problems

**W**hile investors and analysts worldwide
**H**ave differences of opinion
**A**lmost everyone believes the central banks can solve the problems
**T**oo bad history shows that is not the case

**W**hether you are Team Persistent or Team Transitory
**I**nflation remains the most significant issue for virtually every economy
**L**owering current CPI readings remains crucial
**L**ack of the ability to quickly do so remains prevalent

**J**ob growth was very impressive
**A**lmost too good to be true
**Y**ields exploded higher with a steeper curve inversion

**D**eep problems within an economy
**O**ften require far more pain than has so far been felt before they are solved

By now, you are all aware that the payroll report was significantly stronger than expected, at least on a headline basis. NFP of 528K with a revision higher to June's data. The Unemployment Rate fell to 3.5%, back to its 50-year lows and another sign that the economy retains a fair amount of strength. Wages rose sharply as well, up to 5.2% Y/Y, although obviously still well below the current inflation rate. However, that wage data was clearly upsetting to the Fed as their gravest concern appears to be the onset of a wage-price spiral. While perhaps this would be picking nits over a strong report, there were two things that were less optimistic, and may yet prove to be quite important. The Participation Rate fell a tick to 62.1% and remains well below pre-Covid levels, and the Household Survey, the one that determines the Unemployment Rate, showed a substantial increase of 303K people who were working part-time for economic reasons, generally meaning their hours were cut and never a sign of economic strength.

The question at this time, as we await the July CPI data to be published Wednesday morning, is how can we expect the Fed to respond to this new data? Remember, they have been very clear that they are "data dependent". Well, the first shot across the market's bow was made by one of the more reticent Fed Governors, Michelle Bowman, who speaks on market conditions only rarely. In a speech Saturday, referring to the Fed's two most recent rate hikes of 0.75%, she explained, *"My view is that similarly-sized increases should be on the table until we see inflation* ***declining in a consistent, meaningful and lasting way****."* [emphasis added] As a governor, Ms Bowman is a permanent voter, thus implying at least one vote for 75bps in September. Meanwhile, SF Fed President Mary (I don't feel the pain) Daly said the Fed is "*far from done yet*" and was clear that a 50bp hike was not locked in for the next meeting. The implication here is that 75 is clearly on the table. While Ms Daly is not a voter, she is clearly on a mission to explain to the markets that they are underestimating the Fed's resolve.

Given the combination of summer doldrums, with many market participants away on holiday and the dearth of market liquidity, as evidenced by this morning's trading activity showing today's FX volumes running between 15% and 35% of normal, you can be sure all eyes will remain on Wednesday's data point as the next really crucial piece of information. Here is a look at what the week brings as a whole:

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|---|---|---|
| Tuesday | NFIB Small Biz Optimism | 89.5 |
| | Nonfarm Productivity | -4.6% |
| | Unit Labor Costs | 9.6% |
| Wednesday | CPI | 0.2% (8.7% Y/Y) |
| | -ex food & energy | 0.5% (6.1% Y/Y) |
| | Wholesale Inventories | 1.9% |
| Thursday | Initial Claims | 265K |
| | Continuing Claims | 1410K |
| | PPI | 0.3% (10.4% Y/Y) |
| | -ex food & energy | 0.4% (5.9% Y/Y) |
| Friday | Michigan Sentiment | 52.5 |
| | Mich 1yr Inflation Exp | 5.1% |
| | Mich 5-10yr Inflation Exp | 2.8% |

Source: Bloomberg

We also have three more Fed speakers scheduled, Evans, Kashkari and Daly (again), three of the most dovish Fed members. This is clearly an orchestrated effort by Chairman Powell to get the market to understand that the doves are on board for a lot more tightening and the market is underestimating the Fed's resolve, and by implication just how high interest rates may go.

Finishing up with a tour of markets shows that US investors are not the only ones who don't seem to believe the central banks when they claim they will not stop until inflation is well and truly dead. In Asia, the Nikkei (+0.25%) and Shanghai (+0.3%) both managed to rise on the day although the Hang Seng (-0.75%) suffered on the back of concerns over the Chinese tech sector. Europe, however, has started to gain momentum to the upside with the DAX (+0.7%), CAC (+0.9%), and FTSE 100 (+0.5%) all moving up nicely after a slow start this morning. Finally, after a mixed session Friday in the States, where only the Dow managed any gains, its all green today with gains between 0.5% and 0.8% in the futures markets.

Meanwhile, bond investors are clearly reading from a different book as yields tumble across the board, Treasuries are lower by 4bps and we are seeing even larger rallies (yield declines) in Europe (Bunds -6.0bps, OATs -5.2bps, Gilts -7.7bps) as investors continue to price in a pretty strong recession and expect the central banks, notably the Fed, to pivot from the current hawkishness to rate cuts in less than twelve months. The US yield curve remains steeply inverted at 40bps, certainly indicating a recession is coming, but with vastly varying opinions as to when it will arrive, or if it has already done so.

Oil prices (-1.75%) are definitely in the recession camp as they are now back to levels last seen pre the Ukraine invasion, while NatGas (-3.9%) is falling on those same recession fears as clearly, the heat wave has not come close to ending. Gold (+0.5%) continues to hold its own and is now a solid $100/oz higher than its recent lows although copper (-0.15%) is a touch softer. The key to remember with copper is that it has already deflated some 30% from its highs seen in March, so that is likely a large part of any recession related decline.

Finally, the dollar is softer vs. all its G10 counterparts today with AUD (+0.95%) and NZD (+0.9%) leading the way on the back of apparently stronger Chinese growth based on weekend data on trade. However, if China is rebounding, I would expect oil prices to do the same, so something seems amiss here. The rest of the bloc has been a little less exuberant although SEK (+0.6%) and CHF (+0.5%) are having pretty solid days in their own right.

EMG currencies had a bit different take on Friday's US data with the APAC set all softening amid concerns that US interest rates were going to rise more sharply, both slowing growth and reducing the attractiveness of these same currencies. So, KRW (-0.6%), PHP (-0.6%) and THB (-0.55%) led the way lower overnight. However, this morning, with the dollar settling back, we are seeing gains in ZAR (+0.65%) and MXN (+0.5%), seemingly on optimism that the mooted Fed pivot is going to help prevent a recession of any sort, while the rest of the EEMEA bloc has only edged a bit higher.

And that is really the scoop. With no data nor scheduled Fed speakers, today's FX market activity will almost certainly follow the risk metrics of the equity and bond markets. Of course, given they are pointing in opposite directions, I would estimate that we will not see too much activity or movement.

Good luck and stay safe
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