SMBC Capital Markets, Inc.

fxPoetry

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Somewhat Contested

The idea inflation has crested
This morning's been somewhat contested
In England, at least
Inflation's a beast
As everyone there has attested

In fact, the Old Lady explained
That thirteen percent was ordained
So, folks over there
Expect more despair
As ten percent's what's been attained

While the narrative in US markets continues to be that inflation has peaked and that the Fed will quickly be backing off their aggressive rate hiking path with a probability they start cutting rates in the middle of 2023, that narrative does not seem to have international applications. (And quite frankly, my take is that narrative is completely wrong to boot.) Consider the situation in the UK, where this morning CPI printed at another new high for the cycle, 10.1% with the core reading at 6.2%. RPI, an anachronistic British inflation reading is much higher at 12.3% and PPI rose to 17.1%. It certainly doesn't feel like inflation has peaked in the UK. Now, kudos to BOE Governor Andrew Bailey, who two weeks ago, upon raising the base rate by 50 basis points, explained they expected inflation to rise to 13.1% later this year while the UK economy slipped into a 5-quarter recession.

The most remarkable thing about the Bailey comments was not the nature of the forecast, but rather the fact that he was willing to put his name to them. I cannot remember a central banker willing to admit that a recession was coming or that inflation would rise further since, arguably, Paul Volcker back in the early 1980's.

The key question for market participants is whether the UK is a microcosm of the global economy, with higher prices and stagnant growth, or an idiosyncratic outlier. At this point, the jury is still out on the subject, but there is certainly evidence that the UK is a harbinger of what is to come elsewhere.

In today's world, energy remains one of the key drivers to an economy's performance and those nations that are large energy importers clearly face much greater headwinds than those that are energy producers. But energy markets are mostly global, so high prices impact every nation. Combine the still very high energy prices with the fact that most of the western world are energy importers and it is very easy to construct a story of higher prices and slower growth. In fact, the US is the outlier here as we are a net energy exporter. And while absolute energy prices in the US are lower than elsewhere in the world (both gasoline and natural gas) they have still risen exceptionally over the past year. As to the future, economic theory would tell you that US energy prices and global energy prices are likely to converge at some point, thus resulting in higher prices in the US (and lower prices elsewhere). But that theory does not account for governmental policies that ~~will~~ may lead to inefficiencies and, thus, higher prices than necessary. Chief amongst those policies is the potential for Russia to cease exporting natural gas to Europe in an escalation of the Ukraine conflict, thus driving energy prices in Europe even higher with knock-on effects everywhere else.

The key is that as energy prices rise, the cost of production of many things rises concurrently although the cost of the products may lag. As such, we continue to see companies announce cutbacks and cessations of production in things like fertilizer and aluminum because they are no longer economic. The problem is that those are products that have critical uses for other products and reductions in supplies of those basic goods will translate into reductions in supplies of the next level of production like food and machinery. It is not hard to see how prices of these secondary products will rise as well once supplies of their inputs shrink. And all of this completely ignores things like wages which get a great deal of attention. The point is that the wheels of inflation continue to turn and point to a much longer period of rising prices than the narrative is currently indicating. While inflation at 5% is certainly better than inflation at 9%, it is still remarkably uncomfortable and will result in behavioral changes throughout the economy. It is for this reason that the question of the UK's 'leadership' on this subject is so important.

As an aside, next Thursday we will hear from Chairman Powell as he opens the Jackson Hole Conference, and all eyes and ears will be on his comments regarding the future and the Fed's possible reaction function. Since the last FOMC meeting three weeks ago, despite a steady stream of Fedspeak indicating the FOMC was not nearly done raising rates, investors remain certain that the tightening cycle is about to end and have ignored all of it. But will they ignore the Chairman? We shall see.

The defining feature of today's markets are bonds, where after the UK CPI reading, bond yields around the world jumped sharply. In fact, Treasuries are the best performers of the day with yields only higher by 7.1bps, while throughout Europe yields have moved much more sharply (Bunds +11.8bps, OATs +12.5bps, Gilts +13.5bps and BTPs +17.2bps). So, not only are all yields higher, but the Bund - BTP spread continues to widen further. The ECB cannot be happy with the situation today. What about the yield curve inversion you may ask? Not to worry, it remains extremely inverted at 44bps, not quite the highest level seen recently, but certainly not showing any signs of reversing.

Equity markets, meanwhile, have responded to the UK data in a negative manner. Overnight, before the print, the Nikkei (+1.2%) led gains across the region with both the Hang Seng and

Shanghai gaining 0.45%. But now Europe is in the red (DAX -1.15%, CAC -0.6%, FTSE 100 -0.4%) and US futures are also looking down (-0.75% on average) at this hour.

In the commodity markets, oil (0.0%) has begun to consolidate after its recent decline on the combination of recession fears reducing demand and hopes that an Iran accord may be reached, thus adding supply to the market. NatGas (+1.4% in the US, +2.25% in Europe) continues to rally as German officials have been explaining that even if they get reserves up to 95% of capacity, they are still reliant on Russia or could run out of gas this winter. Gold prices (-0.4%) have been sliding on the back of dollar strength while copper (-1.0%) is suffering on growing recession fears, notably in China and now Europe.

Finally, the dollar remains on a roll, rising against all its G10 brethren with AUD (-1.3%) the worst performer on the back of ongoing concerns over Chinese growth, and NZD (-1.0%) despite the RBNZ raising rates the expected 50bps last night and forecasting a terminal rate of 4.1% compared to the current rate of 3.0%. But the whole bloc is softer vs. the dollar. Special notice of the yen (-0.7%) which is responding to the rebound in US yields.

In emerging markets, ZAR (-1.6%) is the worst performer today after the central bank indicated that a return to their inflation range of 3%-6% is "likely to be sluggish" thus undermining the currency. PLN (-0.85%) is also weak this morning after poorer than expected GDP print of -2.3% Q/Q. The rest of the bloc is generally softer, but to a much lesser extent.

On the data front, today is the week's big day with Retail Sales (exp 0.1%, -0.1% ex autos) and then the FOMC Minutes at 2:00. While I generally believe the Minutes have lost their luster given the amount of Fedspeak we typically get, this month, given the questions of how things are going to proceed, there is a heightened awareness of the comments.

Looking at the market as a whole, the UK CPI set the tone and has investors on the back foot. We will need to see very strong data to help change that tone, or we will need to hear from the FOMC that 75 was not widely appreciated and an easier policy is more appropriate. I don't anticipate the latter, so think the dollar will continue its winning ways.

Good luck and stay safe
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