SMBC Capital Markets, Inc.

fxPoetry

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Her Latest Canard

Today we'll hear Madame Lagarde
Expand on her latest canard
That they have the tools
Since they make the rules
To make sure the PIGS aren't scarred

But markets are funny old things
And don't always listen to kings (or queens)
So, traders may sell
Their PIGS debt pell-mell
Regardless the arrows and slings

We all know that the ECB is today's lead story as we await the news on exactly how they expect the next steps in policy tightening to occur. In an ideal world, they will simply stop purchasing all government bonds and slowly raise interest rates as companies and people throughout the Eurozone recognize that there is no need to either raise prices or keep paying up for items as all of the recent price increases are simply temporary (and Putin's fault) and then inflation will follow their models and fall back to low levels. In fact, in Lagarde's view, the key concern remains that inflation will be too low in the not-too-distant future, so that must be prevented at all costs.

Alas, reality has a funny way of intruding on the dreams of central bankers, and all politicians in truth, and I fear the process of removing the excess policy accommodation that the ECB has been pumping into the economy will be a bit bumpier than those dreams. While both inflation and economic growth are clearly key initiatives for the ECB, I believe there is a much larger concern that drives all policy, the maintenance of the Eurozone as a viable entity. After all, if the clearly diverging fortunes of the different nations within the group reached a point where policy designed to help one (say ultra-easy money and QE of Italian bonds) resulted in unpalatable negative consequences in another (say rocketing inflation and slowing growth in Germany) then one of those nations may decide it is better off on its own. And if the Eurozone were to fracture, what would be the purpose of the ECB?

Which brings us back to what, exactly, is the ECB going to do? At this point it is abundantly clear that they are going explain the Asset Purchase Program (QE) will end early in the third quarter, arguably on July 1st, as early as you can get. This will give them several weeks before the next meeting and their first opportunity to raise the deposit rate from its -0.50% level of the past three years. In fact, I suspect we will get something of a timeline for when that deposit rate may actually rise above 0.00%, something not seen since September 2012.

The monkey wrench in this process is the European sovereign bond market where the myth of riskless government bonds was shattered during the Greek crisis in 2012, and where the PIGS find their yields slowly grinding higher vs. the benchmark German bund. An extra concern is that bund yields continue to rise in their own right, having gained 150 basis points (from -0.18% to +1.34%) since the beginning of 2022. Add that gain to the fact that the spread between bunds and PIGS bonds is widening as well and you have the makings of another debt crisis.

Now, when a central bank has a debt crisis problem, the first tool pulled out is buying government bonds to stabilize markets. But that is antithetical to the ECB's goal of selling government bonds to remove accommodation. As such, it is not clear what kind of tool they can create that can simultaneously buy and sell bonds and have an impact. Well, perhaps that is not completely correct. They can simply sell all their bunds and Dutch and Austrian bonds while continuing to buy PIGS bonds in order to stabilize the market. However, that would result in a central bank with very low rated assets and lead to other concerns down the road. In other words, there doesn't appear to be any good solution to this problem, at least not a stable long-term solution.

Looking back at the last time this occurred, Signor Draghi uttered his most famous words, "we will do whatever it takes, and believe me, it will be enough." Interestingly, they didn't really do anything, but the market believed him. However, Mario Draghi was a central banker of long standing and widely respected as an economic policymaker. Will the market accord Madame Lagarde the same respect? I guess we shall see, but I have my doubts.

Heading into the ECB meeting results, and perhaps more importantly the press conference to be held at 8:30am NY time, markets have had a bit of a malaise with equity markets in Asia (Nikkei 0.0%, Hang Seng -0.65%, Shanghai -0.75%) mostly under pressure despite a story, since refuted, that the Chinese were going to finally allow Ant Financial to go through its IPO. European bourses are also under pressure (DAX -0.55%, CAC -0.2%, FTSE 100 -0.4%) despite a dearth of either news or comments. Arguably, these markets were mostly following yesterday's US equity sell-off, which saw steady weakness throughout the day. Interestingly, US futures are all in the green this morning, up about 0.5% as I type.

Bond markets are mostly a touch higher after a pretty sharp decline yesterday as Treasuries are basically unchanged on the day, hovering just above the key 3.00% level, while bunds (-0.6bps) and OATs (-1.5bps) are both seeing some small demand. Gilts (+2.6bps) on the other hand are under pressure, although there is no strong story here either. This movement appears to be position adjustments as traders and investors await the first big story of the week, the ECB, and look forward to tomorrow morning's CPI data from the US.

Oil prices (0.0%) are unchanged this morning but that means they are retaining the large gains seen this week which are in excess of 3%. NatGas, however, is a different story as it tumbled in the US yesterday and is down a further 4.75% this morning, on the story that a fire at an LNG processing facility in Texas is going to shut that down for about 3 weeks. This will cut the amount of LNG exports in half for that period of time, thus allowing tanks to be topped up in the US while leaving the export destinations (mostly the UK it seems) undersupplied. As such, it should be no surprise that European NatGas (+9.4%) and UK NatGas (+24.6%) are much higher this morning. Gold (-0.3%) is a few bucks lower, but still hovering around the $1850 level biding its time. Copper (-1.1%) and aluminum (-1.0%) are both under pressure as well, certainly not signs of economic strength. It appears that there is more concern from China as Shanghai just locked down 10% of its population for renewed Covid concerns. We will obviously be hearing more about that going forward.

Finally, the yen is suffering (benefitting from?) a short squeeze and has rebounded about 0.7% this morning. Nothing has changed with respect to policies on either side of the equation, but after touching yet another new dollar high for the move early in the Asian session, things have reversed. But other than that in the G10, there is no theme ahead of the ECB with some gainers and losers and all the movements subdued. In the EMG bloc, IDR (-0.5%) is the worst performer on rising inflation fears and then TRY (-0.45%) which is going to continue to fall until that policy insanity ends. But otherwise, not very much. One thing that may be worth watching is the correlation between JPY and CNY as thinking back to the Asian financial crisis of 1998 reminds us that neither country is willing to allow the other to competitively devalue its currency without limit. So, if the yen really does continue to weaken, I might look for the renminbi to do the same.

On the data front, just Initial (exp 206K) and Continuing (1303K) Claims are on the schedule and there are no Fed speakers. Once again, the FX market will be beholden to broader risk sentiment, so I would keep an eye on the 10-year as my primary driver, and stocks after that.

Good luck and stay safe
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