SMBC Capital Markets, Inc.

fxPoetry

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Talk Remains Cheap

Said Madame Lagarde, rates will rise
Come Q3, or so we surmise
Now, I'm a supporter
It should be a quarter
Though, for fifty, there have been cries

Regardless of how much they raise
This clarity has garnered praise
But talk remains cheap
And making that leap
Is subject, still, to more delays

> *"I expect net purchases under the APP to end very early in the third quarter. This would allow us a rate lift-off at our meeting in July, in line with our forward guidance. Based on the current outlook, we are likely to be in a position to exit negative interest rates by the end of the third quarter.* ***This means that it is sensible to move step by step****, observing the effects on the economy and the inflation outlook as rates rise."*
> Christine Lagarde May 23, 2022 [emphasis added]

While the more hawkish members of the ECB continue to want to see a rapid adjustment in policy, (I'm looking at you Klaas Knot) Madame Lagarde is being dragged to this point kicking and screaming and so will insist on a very measured pace. While fifty basis points has become the currency of the realm in central bank world, with all the big banks going there, she will not be bullied. At least, so she says for now. Given inflation is running at 7.5% in the Eurozone, a mere 3.75 times their target, the fact that THEY ARE STILL BUYING ASSETS TODAY remains extraordinary.

Of course, in the case of the ECB, Lagarde's concern is that Italy will find far fewer buyers of its BTPs when the ECB steps away. The spread between German bunds and Italian BTPs has widened from 138 to 202 basis points over the past six months, an indication that investors are growing increasingly concerned over the ability of Italy to continue down its current economic path.

Perhaps the most telling line in her blog post (the source of the above quote) was, *"If necessary, we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalization, as we have shown on many occasions in the past*." My interpretation, and I am not alone, is that this is the escape valve for how they will continue to buy assets to support PIGS debt as the ECB cannot afford for those nations to come under more intense pressure than the rest of Europe. My money is on the fact that the ECB will still be buying some bonds through 2023 and beyond.

The market reaction, though, was swift and the euro (+1.1%) has rallied sharply as short positions are covered. After the yen, the euro was the next most widely shorted currency, and so it should be no surprise that the clear signal of higher rates withing a few months is seen as a good time to reduce those positions. Can it continue to climb? This depends entirely on whether the Fed maintains its hawkish stance, or doubles down, and ultimately, on whether either central bank achieves what the market is currently pricing. As of this morning, that differential is 230bps (Fed funds at 2.78%, Euro overnight rate at 0.48%) by December. If that spread narrows, the euro should continue to climb and vice versa.

However, other than that news from the ECB, it has been a rather dull session overall. After seven consecutive down weeks in the S&P 500, there is growing angst over how the market will continue going forward. Of course, after seven consecutive down weeks, a bounce would be expected, and so far this morning, that is what we have received. Risk is mostly on, although the magnitude of most movement hasn't been that large. Perhaps investors everywhere are rapt by the goings on it Davos, where the WEF is holding its meeting this week. However, my sense is it is more likely investors are simply trying to get their bearings after the recent decline in asset markets around the world. And just think, neither the Fed nor ECB has actually even started to remove liquidity from the market. I expect there will be much more volatility going forward.

Ok, let's look at markets. While the Nikkei (+1.0%) managed a gain overnight, the Hang Seng (-1.2%) saw continued pressure and remains in a steady downtrend. Shanghai (0.0%) was flat on the day as concerns grow over an increase in reported Covid infections in Beijing and the possibility of a larger lockdown there, while Shanghai slowly starts to reopen. Meanwhile, in Europe, thigs are generally better with the DAX (+0.9%), CAC (+0.4%) and FTSE 100 (+1.1%) all in good shape, perhaps on the back of a very slightly better than expected IFO Expectations reading of 86.9, a level which still portends a recession in Germany. US futures are getting in the swing of things with all 3 major indices looking at 1.0% gains at this hour (7:20am).

Bonds, meanwhile, are under pressure as risk is accumulated. So, Treasury yields (+4.7bps) are leading the way but there is weakness throughout Europe (Bunds +4.9bps, OATs +4.8bps, Gilts +3.6bps). And in case you were wondering, the BOJ has maintained its crushing grip on JGB yields, which actually edged lower by 0.5bps overnight and are now at 0.23%.

Oil prices are perkier this morning, up 0.9%, although NatGas (-1.6%) is under a bit of pressure. As the temperatures rise, demand for NatGas typically declines, although this is the period when storage is replenished, and given the impact of the Ukraine war on Russian gas exports, that will continue to be a problem. Precious metals (Au +0.8%, Ag +1.7%) are regaining some of their luster lately as the dollar has softened. But so, too, have base metals (Cu +0.9%, Al +1.3%) as there is a general sense of positivity in the air this morning. Keep an eye on agricultural products though, as wheat (+1.8%) is making another run at $12/bushel, and the food situation globally is only getting worse.

Finally, the dollar is under pressure universally today, with NOK (+1.4%) and NZD (+1.4%) leading the way higher though even the laggard (JPY +0.3%) is higher on the session. Norway is clearly benefitting from oil's continued strength while kiwi seems to be seeing a combination of short covering and positioning for the RBNZ' rate hike later this week. In the EMG bloc, HUF (+1.55%), PLN (+1.4%) and CZK (+1.2%) lead the way as they demonstrate their high beta compared to the euro, so euro rallies tend to see exaggerated moves in these currencies. But the strength is elsewhere as CNY (+0.7%) is one of the top gainers as hopes are rising that the Biden administration may reduce tariffs on Chinese goods thus supporting additional growth there. And interestingly, there are no decliners today with the dollar being the worst performing currency across the board.

On the data front, we have a decent amount of info including the second look at Q1 GDP:

Tuesday	PMI Manufacturing (Prelim)	57.8
	PMI Services (Prelim)	55.3
	New Home Sales	750K
Wednesday	Durable Goods	0.6%
	-ex transport	0.6%
	FOMC Minutes	
Thursday	Initial Claims	210K
	Continuing Claims	1310K
	Q1 GDP	-1.3%
Friday	Personal Income	0.5%
	Personal Spending	0.7%
	Retail Inventories	2.0%
	Core PCE Deflator	0.3% (4.9% Y/Y)
	Michigan Sentiment	59.1

Source: Bloomberg

Aside from GDP we will see the FOMC Minutes, which may give us a little more clarity on their thinking, although given how much they all talk these days, it is hard to believe they haven't already told us whatever is in there. As well, Core PCE comes Friday, and that is their number. Adding to the mix will be four speakers, including Chairman Powell tomorrow morning.

This correction is long overdue and given the catalyst of a surprisingly clear message regarding ECB rate hikes, not that surprising. Can it continue? As I indicated above, as long as the market continues to believe that the Fed will remain the most aggressive when it comes to tightening policy, I believe the dollar will continue to rally. If other banks are seen as stepping up more aggressively, then the dollar is likely to cede some of its recent gains.

Good luck and stay safe
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