SMBC Capital Markets, Inc.

fxPoetry

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Volcker as Muse

It seems we are watching a race
Twixt central banks making the case
That policies, tight,
Are all they've in sight
With only the question of pace

Three-quarters is now the new norm
And less would no longer conform
With central bank views
And Volcker as muse
Despite chances for a sh*tstorm

High and rising inflation, soaring gas and electricity prices, out of control government spending. It seems like only yesterday when these issues were on the tip of every pundit's tongue and were the key features driving markets. With the Fed in the tight policy lead, the dollar was on a mission higher. With Putin still dominating the conversation, the fate of Ukraine as well as Western Europe this winter were increasingly called into question. And all of this was feeding into higher prices everywhere thus driving rising inflation and slowing economic growth. It was a perfect storm of terrible things with no end in sight.

But that fear mongering is so last month it no longer has any bearing on things, at least that's the way it seems. With the calendar having turned to September and the beginning of autumn, it seems that a new narrative has formed. The Fed has gone from behind the curve to on top of things. Gas and electricity prices, especially in Europe, have declined by more than 40% from late August blow-off tops, and more importantly, despite NordStream 1 having been completely shut down by President Putin, Europe has filled their gas tanks to the tune of 85% on average across the continent, thus reducing fears of complete shutdowns this winter. Of course, rationing does still seem to be likely depending on the winter weather, but there is no real fear of running out of power.

Meanwhile, the news last night of a major counter offensive by Ukraine, with the recapture of 1000 square kilometers of land in the Eastern part of the country with the byproduct of cutting Russian supply lines has changed a lot of the calculus about the outcome of the war with a Ukrainian victory getting more voice.

All this has led to expectations that the central banks have won the inflation war. And perhaps they have…but it feels a little early yet to declare victory. Never before in history has inflation, once it has reached 5%, been successfully reduced without interest rates rising above the rate of inflation. And while every single Fed speaker, and ECB speaker for that matter, has been extremely clear that they will not be deterred, given the current level of short-term interest rates (2.5% in the US, 0.0% in Europe) and recent readings on inflation (8.5% in the US, 9.1% in Europe) it could easily seem as though there is a lot more monetary tightening yet to come.

There is one other part that we missed, and that is any change in government spending. In fact, if anything, it seems that part of the equation is continuing to move in a more problematic direction. New UK PM Liz Truss has put forth her plan to cap household energy bills at £2500 per year with caps for businesses as well. The idea is that the government is going to make up the difference, but that means spending a lot of public money, money the government doesn't currently have in hand. So, funding this policy will require either raising taxes or a lot more borrowing with the latter the almost certain direction of travel. Estimates are for £100 billion each year this goes on, which represents about 4% of the total economy and nearly 10% of the government budget. Yields on 10-year Gilts are currently over 3%, their highest point since 2011. It seems likely that they could go a bit higher as the UK government seeks to pay for this largesse.

And don't think the UK is alone in this process. While their plan is simply the most recent and widely reported, throughout all of Europe governments are planning to spend public funds to offset the high cost of energy with no end in sight. There are still many financial questions to be answered going forward.

And what about the dollar? Well, with the narrative change, so too has the dollar story changed. From unabashed strength to completely on its heels in one week. No longer is the Fed seen as running that far ahead of everybody else (except maybe the BOJ) with the ECB's 75bp hike last week and talk of another one next month supporting the single currency admirably. But more importantly, the decline in energy prices, although they remain substantially higher than last year or any time in the past decade, has also reduced pressure on other nations demand for dollars as they require fewer to pay for their oil and gas.

Here, though, the narrative change seems likely to have a longer-term impact as well. Consider the fact that one of the features of markets over the past decade has been the extraordinary flow of capital from surplus nations (Japan, Germany, Switzerland, etc.) to a particular debtor nation (US). This has been a large part of the extraordinary rally in US equity prices seen since the GFC lows in March 2009. In fact, a quick look at the balance sheet of the Swiss National Bank shows they hold >$147 billion in US equities amongst their $1 trillion balance sheet. And this is for an economy of ~$900 billion with a population of 8.6 million. The point is, these surplus countries, facing harder times because of high energy prices, may decide that bringing home some of those surpluses and using them domestically is the appropriate action, both economically and politically. And that, my friends, would be a long-term negative for the dollar. Just something to keep in mind.

I apologize for the long intro, but I was out for a few days when a lot happened! So, let's look at today, where rose-colored glasses are clearly the norm. Equity markets around the world are all in the green with Asia (Nikkei +1.2%, Hang Seng +2.7%, Shanghai +0.8%) starting the week off nicely and Europe (DAX +1.6%, CAC +1.2%, FTSE 100 +1.4%) also powering ahead as the idea that the worst is past permeates the investor community. US futures are also higher at this hour (7:05am) albeit not quite as impressively with gains of about 0.4%.

Bond markets are also in favor today as yields are softer across the board. Treasuries (-2.1bps) are indicative of the overall price action with Europe (Bunds -3.6bps, OATs -3.8bps, Gilts -1.9bps, BTPs -5.5bps) all seeing the love as well. This appears to be the result of two of the narrative pieces, softening energy prices and concomitantly, expectations that the peak in inflation has been reached and the central banks will begin backing off. It seems to me that the central banks, or at least the Fed, has been abundantly clear they are not quitting anytime soon, but markets have their own ideas.

Oil prices (+0.6%) which had sold off aggressively last week, have rebounded and appear to be grinding higher overall. The two key oil stories seem to be the imminent recession and the ongoing Covid zero policies in China. However, there is increasing talk of a 'soft landing' avoiding a recession as well as the idea that once past the Communist Party congress next month, President Xi is going to pivot to something a bit less draconian and allow the Chinese economy to run. Both of these will support the price of oil, as will the structural shortage that continues to exist (and will for at least the next decade). NatGas (+1.3%) is also continuing its rebound although in Europe (-7.3%) the story is different based on the perceived safety levels achieved. Metals markets (Au +0.6%, Cu +0.3%, Al +0.8%) are all benefitting from a clear risk appetite this morning.

Finally, the dollar is weaker against virtually all its counterparts today, following the trend of the past several sessions. In the EMG space, HUF (+1.3%) and ZAR (+1.25%) lead the way followed by CZK (+1.0%) and the rest of EEMEA. APAC currencies were a bit less robust, but mostly firmer and LATAM is opening stronger as well (MXN +0.45%). But the story everywhere is the dollar, not the individual currencies. In the G10, SEK (+1.3%) is the leader in the clubhouse, with the EUR (+0.9%) next followed by NOK (+0.85%) and GBP (+0.75%). While we did see a lot of UK data, it was actually a bit disappointing regarding GDP (0.2% in July) and IP (-0.3%). But, here, too, it is all about the dollar under pressure rather than a particular currency's strength.

With the Fed in its quiet period after Chairman Powell's reiteration of his determination to stay the course last Friday, we have two key pieces of data this week, CPI and Retail Sales:

Tuesday	NFIB Small Biz Optimism	90.5
	CPI	-0.1% (8.0% Y/Y)
	-ex food & energy	0.3% (6.1% Y/Y)
Wednesday	PPI	-0.1% (8.8% Y/Y)
	-ex food & energy	0.3% (7.1% Y/Y)
Thursday	Initial Claims	226K
	Continuing Claims	1477K
	Empire Manufacturing	-13.9
	Retail Sales	0.0%
	-ex autos	0.0%
	Philly Fed	3.0

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	IP	0.1%
	Capacity Utilization	80.3%
	Business Inventories	0.6%
Friday	Michigan Sentiment	60.0

Source: Bloomberg

Despite the fact that the Fed's models utilize core PCE, Chairman Powell made it clear that they are watching CPI closely. 75bps is baked in for next week's meeting and can only really change if this CPI number is a big miss, one way or the other.

The new narrative is strong right now and that implies that this dollar correction has further room to run. However, it is not clear to me that the dollar has seen its highs. Ultimately, I still like it much higher, however not today.

Good luck and stay safe
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