SMBC Capital Markets, Inc.

fxPoetry

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Quite a Fright

The question of growth or recession
Continues to be our obsession
So, data last night
Might cause quite a fright
To growth fans inside the profession

The PMI data all stank
But that helped risk assets outflank
The havens worldwide
As bad news is tied
To ease by each land's central bank

Clearly, bad news is good again. That is the only conclusion that can be drawn from the fact that Manufacturing PMI data throughout the Eurozone as well as in China, two of the three largest economic blocs, fell below 50. The damage is as follows: China 49.0; Italy 48.5; France 49.5; Germany 49.3; Eurozone Composite 49.8. That is not pleasant reading for the policymakers who continue to try to convince us that there is no recession brewing. But if you are an investor, or perhaps you are an investing algorithm, this negative data is manna from heaven as it appears the widespread belief of the Fed's (and most central banks) reaction function is to ease monetary policy when growth slows down. This is despite the tough talk we have heard from Chairman Powell and his minions along with several ECB Council members (albeit not Madame Lagarde).

For instance, just yesterday, uber-dove Neel Kashkari explained on TV, "*We are committed to bringing inflation down and we're going to do what we need to do.* ***We are a long way from achieving an economy that is back at 2% inflation*** *and that's where we need to get to."* [emphasis added]. Now, if Chairman Powell had uttered those same bolded words, I am pretty sure that the market response would have been a bit different. But to the extent that one of the two most dovish members of the Fed believe that there is still a long way to go to achieve price stability (and there is), it seems likely that the attitude at the FOMC is quite a bit more hawkish than the Fed funds futures markets are currently pricing. The market is currently pricing in a 30% probability of a 75bp September rate hike, but with a long time to go before the meeting, that is certainly going to change in the interim. While there are only three scheduled Fed speakers this week, Evans, Mester and Bullard, I would not be surprised to see more informal interviews by other FOMC members as they try to massage the message. If Kashkari's comments are the first volley, I expect to see many more hawkish remarks as the weeks progress.

Now recall, Chairman Jay binned forward guidance as a tool, explaining the FOMC would be data dependent going forward. But I believe they don't consider these statements and speeches as forward guidance, rather they see them as necessary corrections to the market's perception of their goals. So, while the FOMC statement will no longer tell us 'lower for longer' or things of that nature, I assure you the Fed will not sit by mum if they believe the market is misinterpreting their actions. Thus, it will be interesting to see if the hawks are back on the tape over the next several weeks, pushing back on the pivot idea despite clearly diminishing growth.

Remember, though, talk is cheap. Another place to look and see if the Fed is aggressively tightening policy is the balance sheet to help determine if QT is moving along at their anticipated pace. The latest data does not make for pleasant reading for those who expected the Fed to shrink their balance sheet. Treasury securities on the balance sheet fell by $798MM while MBS fell by $2.63B. Again, this is a far cry from the $47.5B monthly pace they had intimated when they started the program.

One other thing to keep in mind is that despite all the talk about eventually shrinking the balance sheet by upwards of $3 trillion, it seems highly unlikely that will be possible. By definition, reducing the amount of assets will require an equal reduction in the Fed's liabilities. However, it is simply not clear that there are enough liabilities available to be reduced. Currency in circulation seems unlikely to shrink, as do things like the TGA or deposits by foreign central banks. This leaves two main items, bank reserves and reverse repos. As to the former, given the structural and regulatory changes in banking, that number is unlikely to decline very much as major commercial banks are required to keep liquid assets, central bank reserves being amongst the best to hold. As to reverse repos, if they shrink that, the problem is money market funds will find themselves with nothing in which they can invest, and therefore an entire segment of the money markets is likely to stumble. Clearly, the Fed is not going to allow that to happen. All told, estimates that I have seen demonstrate it is unlikely the Fed reduces its balance sheet by more than $900B before problems set in. Of course, at the current pace, that could still take many years!

With that in mind, how have markets behaved? Well, risk is on, at least at the margins, but after a huge equity month in July, follow-through has so far been muted. Asian markets (Nikkei +0.7%, Hang Seng 0.0%, Shanghai +0.2%) were generally green but not hugely so. Aside from the weak Chinese data, Japan's PMI was solid, but sales data was soft. Europe, too, is in the green (DAX +0.4%, CAC +0.3%, FTSE 100 +0.4%) despite the soft PMI data there. Adding to the soft data story was German Retail Sales (-1.6% M/M, -9.8% Y/Y) which were much worse than expected. In fact, the only positive was the commentary by poll leading Giorgia Meloni, the leader of the FDI party regarding her willingness to stick to Italy's commitments regarding the EU if she is elected. This has helped not only the FTSE MIB (+1.5%), but BTPs (-7.2bps) as well.

Speaking of the bond market, while Treasury yields are unchanged at 2.65%, the curve inversion continues to grow, now at 25bps. However, European government bonds are all softer today (Bunds +1.8bps, OATs +1.8bps, Gilts +2.3bps) despite the soft PMI data. Sometimes things don't make a lot of sense.

In the commodity markets, oil (-1.6%) is softer but that has more to do with the change in the front contract from July to August than with shrinking demand. NatGas (-2.8%) has slipped as well as the heat wave in the US seems to be abating a bit. One conundrum in this market has been the fact that despite the temporary closure of the Freeport liquification plant in Houston, which was expected to result in a buildup of inventories in the US, those inventories have not built up, and are, in fact, below the 10-year average currently. Look for prices to rise further here. Meanwhile, the situation in Europe remains highly uncertain although the EU is trying to prepare for a winter with no Russian gas at all. Prices there continue to rise with gas now nearing $70/MMBtu in Europe compared to $8/MMBtu here in the States. Meanwhile, metals prices are mixed with gold (+0.4%) continuing its recent rally, copper unchanged and aluminum (-1.9%) sliding.

The dollar, though, is generally soft today led by the JPY (+0.7%) which has actually given back some of its earlier gains and continues to befuddle the market. With short yen being an extremely popular position, this short squeeze likely has further to go. But NZD (+0.9%) and AUD (+0.8%) are both rolling as well as traders anticipate the potential for a more hawkish RBA tonight. In the EMG space, THB (+2.2%) leads the way higher after a surprisingly strong PMI print indicated Thailand may avoid some of the worst economic pain. Similarly, HUF (+1.2%) was also the beneficiary of strong PMI data, which was clear to see vs. Eurozone weakness. On the downside, KRW (-0.4%) was the worst performer as PMI data there disappointed, printing below 50, with PHP (-0.3%) also suffering from worse than expected data.

It is a big data week here in the US culminating in payrolls on Friday.

Today	ISM Manufacturing	52.0
	ISM Prices Paid	73.5
Tuesday	JOLTS Job Openings	11.0M
Wednesday	ISM Services	53.7
	Factory Orders	1.1%
Thursday	Initial Claims	260K
	Continuing Claims	1338K
	Trade Balance	-$80.0B
Friday	Nonfarm Payrolls	250K
	Private Payrolls	230K
	Manufacturing Payrolls	20K
	Unemployment Rate	3.6%
	Average Hourly Earnings	0.3% (4.9% Y/Y)
	Average Weekly Hours	34.5
	Participation Rate	62.2%
	Consumer Credit	$27.0B

Source: Bloomberg

So, as we start the new month, all eyes will be on ISM and NFP as the harbingers of growth or recession. On the former front, European and Chinese data does not inspire. As well, interestingly, the ADP Employment Report seems no longer being published as this is the second month in a row without a number. As such, we have no early signs of what Friday's number will be like.

With Treasury yields slumping and the market pricing in a Fed pivot, it should be no surprise the dollar is on its heels today. As long as that remains the case, and while long USD positions are being unwound, I expect the dollar may have a bit further to fall. As such, your dollar view is directly tied to your view of just how staunch Jay Powell's backbone really is; if you believe he means it when they say inflation is the key issue and they will not rest until it is clearly declining, the dollar will rebound from here and go much further. If not…

Good luck and stay safe
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