SMBC Capital Markets, Inc.

fxPoetry

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All He's Got?

Is seventy-five all he's got?
Or will Jay give one hunge a shot?
Today's CPI
Will help justify
His actions, or thicken the plot

His comrades continue to speak
And multiple times every week
Explain their fixation
Is still on inflation
Recession, though, their steps won't wreak

The most recent addition to the 'most important data' list is to be released today; of course, I am referring to CPI. Current expectations are that the headline number rose 1.1% in the month of June taking the Y/Y print to 8.8%. As widely disseminated across virtually every major media outlet, that would be the highest print since December 1981. Meanwhile, the ex-food & energy expectations are that June saw a 0.5% increase with the Y/Y print actually declining to 5.7%. Of course, what has really changed about this data is the fact that even though the Fed's own models use core PCE data, which is designed to print at lower levels, Chairman Powell at his June press conference admitted that they finally figured out that people consume both food and energy and that headline CPI is probably an important number after all. Hence the renewed focus on this morning's release.

The question to be answered by this release is how will markets anticipate future Fed actions. Despite other recent data releases pointing to slowing growth, with even the payroll report called into question over mixed messages between the two surveys, the continuing onslaught of Fed speakers has pointed to a 75bp rate hike in two weeks' time as the Fed remains 100% focused on taming inflation. The Fed funds futures market has clearly listened to this cacophony and is back to pricing in a full 75bps again, having previously reduced some of that pricing amid the weaker data from prior weeks.

But of more interest, I believe, is what may happen if today's CPI prints higher than market forecasts. Here's a thought experiment: headline CPI prints at 9.1% Y/Y after a monthly increase of 1.3%. Core, meanwhile, remains at 6.0% Y/Y. Is 75bps enough for the Fed to achieve their goals? Remember, Powell has maintained that the economy is strong and has the backing of a much higher than expected NFP print from last week. Will James Bullard be the first to say 100 basis points may be appropriate given that combination of facts? In this event, we will almost certainly see numerous pundits raise the specter of a 100bp rate hike, which would be the largest move by the Fed since January 1982, when Paul Volcker raised the Fed funds rate by 300 basis points. Given that was the last time CPI was at this level, there seems to be a certain symmetry to the idea.

There are many analysts who believe that this Fed will not have the gumption to stick with their policy tightening trajectory if the stock market starts to really sell off, or if the economic data turns much worse. After all, the recent history of the institution is to pivot to easier policy as soon as anything starts to wobble. But for the past 13 years, in the wake of the GFC, the Fed has continuously explained that low inflation was the greatest problem facing the country, so they were clearly concerned over a Japanese style outcome of debt induced deflation. But I don't think they are overly concerned about too low inflation anymore and since the political imperative remains to fight rising prices, and tighter monetary policy is the only tool they've got, I am becoming of the belief that they will stay this course longer than many anticipate. Perhaps they will push Fed funds to 4.0% or beyond as they try to slay the inflation dragon. I still believe that is a low probability outcome, but it seems to be growing for now.

To complete the experiment, how might markets respond to this new concept? I expect that it would be quite negative for equities and that the bond market would bear flatten as the yield curve inverts further. I also expect the dollar would rise sharply while commodity prices would suffer amid views of a pending recession. I guess we will know more later this morning.

Meanwhile, ahead of the CPI, here's what's happening. Overnight saw a mixed equity picture with the Nikkei (+0.5%) modestly firmer while the Hang Seng (-0.2%) slipped and Shanghai was essentially unchanged. Europe, though, is under more pressure with the DAX (-1.0%), CAC (-0.75%) and FTSE 100 (-0.75%) all suffering. Looking at the UK, it seems odd risk is out of favor given the much better than expected GDP readings this morning with a monthly gain of 0.5% and IP rising a much stronger than expected 0.9% in May. Arguably, investors remain concerned over the current leadership vacuum there which will begin to be addressed as Tory party members begin their voting on candidates to become the new PM. On the continent, CPI data was confirmed at its earlier releases in both Germany and France, and my sense is there is growing concern there regarding the energy situation and whether or not President Putin will reopen NordStream 1 next week as planned. If he does not, look for European equities to plummet along with the single currency. Finally, after a down day yesterday, US equity futures are higher by about 0.3% across the board.

The bond market is a bit schizophrenic this morning with Treasury yields softer (-1.8bps) but European sovereigns all selling off with yields climbing (Bunds +1.4bps, OATs +1.6bps, gilts +1.0bp). It's always tough on the investment community when both stocks and bonds fall simultaneously, but I think we may be seeing rising concern over the possibility of a Russian gas shut off and the potential negative ramifications of such a move.

Oil (+0.7%) was routed yesterday, falling about 7%, as recession fears and further Chinese covid shutdowns were enough to overwhelm any long-term structural questions. NatGas (+3.8% in the US, +5.3% in Europe) remains in demand as heat waves in both the US and Europe increase demand for electricity in both geographies. In the metals markets, gold (+0.3%) seems to be finding a new home about $100 lower than its previous equilibrium while copper (-0.3%) continues to respond to slowing growth fears.

Finally, the dollar, which tested parity yesterday morning, has slipped back a bit against most of its counterparts. NOK (+0.55%) is the leading gainer in the G10, followed by AUD (+0.5%) and CHF (+0.45%), while only the yen (-0.15%) is sliding on the day. In truth, most of this looks like a trading adjustment given the dollar's recent very powerful move higher. It should not be that surprising that it consolidates a bit every once in a while. But there are no fundamental stories driving things here.

As to the EMG bloc, CZK (+0.4%), KRW (+0.4%) and ZAR (+0.35%) are the leading gainers with much higher than forecast CPI in the Czech Republic leading traders to look for more aggressive rate hikes there. At the same time, the Bank of Korea raised rates by 50bps and remains hawkish while the rand is simply consolidating after recent declines. On the negative side, HUF (-0.3%) continues to suffer as despite a hawkish central bank, the market does not believe they will be able to keep up with swiftly rising inflation.

In addition to this morning's CPI data, we get the Fed's Beige book this afternoon at 2:00, however, there are no scheduled Fed speakers to add to the mix. While thus far today, the FX market seems to be consolidating, nothing has changed the medium-term view that a hawkish Fed remains bullish for the dollar. The only thing that can change that narrative right now is a much softer than expected CPI print later this morning.

Good luck and stay safe
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