SMBC Capital Markets, Inc.

fxPoetry

June 21, 2022

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Fragmentation

The action will be
Appropriate, you will see
We just don't know what

So much to discuss, so little time. Let me start by saying that I will be on vacation for the next two weeks so this will be the last poetry until June 24th.

I expected the ECB to be today's story but the BOJ stole their thunder. Last night, there was an emergency meeting between the BOJ, the Ministry of Finance and the Financial Services Agency to discuss the yen's recent weakness. It seems that this august group is surprised that the yen is falling just because every other central bank in the world as aggressively tightening monetary policy while they remain adamant that their monetary policy of NIRP and YCC is appropriate. However, politically it is becoming a bit tougher for the powers that be in Tokyo to explain the situation. After all, in the past month, the price of oil in yen has risen more than 15% (11% oil, 4% JPY weakness) and it shows no signs of stopping. Apparently Kuroda-san never read HL Mencken as his advice, "be careful what you wish for, you just might get it…good and hard" seems to apply here. Recall, the BOJ's stated aim for the past decade has been to weaken the yen. Suddenly, when the yen is finally weakening, so is the BOJ's resolve.

So, we are made to suffer the impotent warnings of yet another central bank. "*Appropriate actions we can take include a wide variety of options*," claimed the MOF's top currency official, Masato Kanda. The hint was that they would intervene directly in the market to prevent further yen weakness. The problem with this thesis is that history has shown that currency intervention is, at best, a temporary solution to a much deeper, long-term problem. Arguably, the only time it has ever really worked for a major currency was back in 1985 with the Plaza Accord where the entire developed world agreed that the US dollar was too strong, and nations intervened **and** changed policies. The latter is the key, and if the BOJ/MOF don't change their policies, intervention will simply be an opportunity for those who still need to sell yen, to do so at a better level before it weakens further.

Said Madame Lagarde, fragmentation

Of yields twixt each Eurozone nation
Shall not be allowed
As we are endowed
With tools which will cause its cessation

But traders did not seem persuaded
She has ‘what it takes’, so they faded
The euro’s move higher
As they now require
More proof PIGS will not be degraded

Just like a broken clock is right twice a day, I too get it right occasionally. Madame Lagarde did not disappoint with more empty promises about how to handle the widening spread between peripheral Eurozone sovereign debt and German bunds. When Lagarde started her press conference, she explained they would be ending QE by July 1, which in practical terms means this month, and they would be raising rates 25bps at their July meeting, with potentially 50bps in September. Traders took that as quite a hawkish sign as it seemed the ECB has finally figured out that negative interest rates are not an effective counterweight to inflation running at 8.1%, and the euro immediately rallied about 0.5%.

But then, as she has done in the past, she started discussing fragmentation, which is the new term for peripheral yields blowing out and indicated that if fragmentation hampers the transmission of monetary policy, the ECB will “***deploy either exiting or new instruments that will be made available.”*** Naturally she did not indicate which tools would be available for this job, as likely, they haven’t thought of any yet and are simply counting on their jawboning being sufficient to prevent any unwelcome outcomes. In fact, just this morning, Banque de France president Villeroy reiterated the stance, telling us, ”*markets shouldn’t doubt the* [ECB’s] *will to combat fragmentation*.” I have a feeling fragmentation is the new transitory! At any rate, the euro is still lower this morning, breaking below 1.0600 and now down a further -0.35% after yesterday’s greater than 1% decline.

Which takes us to the big news today, US CPI.

The narrative tells us inflation
Has peaked, so today’s calculation
Will show that the Fed
Has gotten ahead
Of rises and their devastation

Here’s what the market expects, at least according to Bloomberg’s median survey results:

CPI	0.7% (8.3% Y/Y)
-ex food & energy	0.5% (5.9% Y/Y)
Michigan Sentiment	58.1

Recently, there have been whispers that it could be higher, which would be a problem for all the folks who explained that March’s 8.5% Y/Y print was the high we would see. It would also be a problem for Jay and his minions at the Fed as it would be another indication that they are falling further behind the curve. Right now, the futures market is pricing a 10% chance of a 75bp rate hike next week with a guarantee of 50bps. But a number at 8.7% or higher could well shift that view pretty dramatically. We shall see.

A quick recap of the overnight price action shows that after yesterday's equity rout in the US, most other markets are feeling the same way. In Asia, the Nikkei (-1.5%) and Hang Seng (-0.3%) both fell although somehow Shanghai (+1.4%) bucked the trend despite news that lockdowns are being reimposed in the city as 6 new cases of Covid have been found for the second consecutive day. In Europe, it is all red with the DAX (-1.4%), CAC (-1.6%) and FTSE 100 (-1.2%) all suffering, just not as much as Italy's FTSE MIB (-3.7%) which is falling for obvious reasons given our discussion on fragmentation above. Interestingly, US futures are mixed with both Dow and S&P futures modestly softer, about -0.2%, while the Nasdaq (+0.1%) has managed to hold on to small gains.

On a risk off day like today, it is no surprise that bonds are a bit better bid although only just. Treasuries (-0.5bps) remain above 3.03% while bunds (-2.4bps) are the best performer of the day. Actually, OATs (+0.8bps) are acting more like peripherals than core bonds, albeit not as badly as Italy and Spain (+3.0bps each). Gilts (-1.4bps) are still seen as havens today.

Oil prices (+0.7%) know no top as OPEC is slowly beginning to admit that they have zero spare capacity and, in fact, cannot even meet their current quotas. NatGas (+0.1%) remains the most volatile of all commodities, arguably in both price and chemistry. Gold (-0.4%) is suffering amid dollar strength but remains above its key support at $1830, while the base metals (Cu -0.7%, Al -1.1%) continue to price in weakening economic activity.

Finally, the dollar is mostly stronger although there have been some gainers at its expense. NZD (+0.45%) leads that short list followed by JPY (+0.4%) and AUD (+0.4%). We all understand the JPY story and the Antipodean currencies seem to be similarly benefitting from a short squeeze to end the week. On the other side of the coin, GBP (-0.5%) is the weakest in this bloc but everything else has fallen by about -0.3%. It seems the pound is suffering as the BOE released the results of a survey showing 12-month inflation expectations are now the highest on record, and yet the BOE remains frozen in time.

As to emerging markets, HUF (-1.0%) is the worst performer followed by KRW (-0.9%) and THB (-0.8%) although declines are virtually universal. The forint is suffering as despite the highest rates in Europe, the central bank is sounding more dovish, and traders are testing their resolve. The won, meanwhile, is feeling the effects of concerns over slowing growth and the broad-based risk-off sentiment pervading markets which seems to be the same story in Bangkok.

And that's what we have. We are all awaiting the CPI data, and then all eyes will turn to next Wednesday's FOMC meeting where 50bps seems guaranteed. Much will depend on just how hawkish, or not, Chairman Powell sounds, but that is a story for next week. For now, barring a surprisingly low CPI print, the dollar seems set to continue its recent rise. Take advantage of any dips to add to hedges at this point.

Good luck, good weekend and stay safe
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