SMBC Capital Markets, Inc.

fxPoetry

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Fatal Conceit

I guess it is time to move on
Inflation is practically gone
Or so says the Street
Whose fatal conceit
Is making, conclusions, foregone

Thus, risk is the flavor today
As equities worldwide portray
A future so bright
Investors' delight
In buying all things, come what may

Were this author a skeptic, he might feel that there is a concerted effort to insist that the Fed has already done the heavy lifting and that they are in the final stages of their tightening cycle. At least that's the case based on the tone of almost every article and comment published over the weekend and this morning. After last week's *WSJ* article from the Fed whisperer, Nick Timiraos, that there was no chance of a 100bp rate hike, which was subsequently seconded by a trio of Fed speakers just ahead of the beginning of the Fed quiet period, it seems that minds have been made up. Yes, inflation is bad, but the Fed is on the case and with Jay Powell wearing his Paul Volcker ~~costume~~ suit, everything is going to be fine. Sure, there might be a recession, but it is going to be short and shallow, at least according to the majority of economists recently surveyed. Of course, these are the same economists who explained inflation was transitory and unlimited printing of money would never be a problem in the new paradigm of the great moderation.

On the one hand, I would love this to be the case as, quite frankly, I am tired of writing about inflation and how it is going to impact both our lives and our investment strategies (as well as continuing to pay higher prices for the same things). On the other, I fear this is a lot of whistling past the graveyard. Arguably, the question is not if a recession is coming (it almost certainly is) but how will policymakers adjust their policies when it hits. If inflation remains the driving force for policy actions, then it seems likely that the recession will drag on far longer than the punditry currently believes and will be deeper as well. (FYI, risk assets are likely to fare poorly in that environment.) However, if the political pain of the recession becomes too great, a distinct possibility, and central banks pivot by explaining inflation is under control, then inflation will not get under control and we will have another, steeper wave of rising prices amid general discontent.

And this is the easy story in the US. Consider the situation in Europe where past energy policy decisions have left the continent at the mercy of a man who is currently waging a war right next door to their eastern border. By Friday, the NordStream 1 pipeline is supposed to be reopened as routine annual maintenance is scheduled to have been completed by then. However, there is a growing fear that President Putin will not open the taps and that Europe will find itself in a very serious situation for the coming winter. They will not be able to replenish their reserves, which currently sit far below 10-year averages and the prospects for rationing amid much higher prices are great. Germany, in particular, will be decimated by this action, as their economy will suffer hugely (estimates range from a 5% - 10% decline) as most heavy manufacturing will be shuttered and the jobs that go along with that manufacturing will disappear, at least temporarily. But the entire continent will be impacted with growth slowing to a halt virtually everywhere, although given the certain rise in energy prices, inflation is unlikely to decline. The ECB, which has been providing liquidity to the continent, in order to keep it afloat, for the past 11 years, will find itself in an extremely uncomfortable position. Very high inflation amid a steep recession does not offer a lot of popular policy choices. It would not be surprising to see the number of protests throughout Europe, which are already large and growing, to really explode higher. If you were looking for a scenario that could lead to a much weaker euro, simply watch what happens to NordStream 1. If it stays shut, the euro will fall much further.

Ok, with that cheery outlook as backdrop, let's see how the market absolutely does not believe any of those views. Equities worldwide are higher as everything is coming up roses. Asia (Nikkei +0.5%, Hang Seng +2.7%, Shanghai +1.55%) and Europe (DAX +1.2%, CAC +1.3%, FTSE 100 +1.2%) are both following on Friday's continued rally in the US. Naturally, this raises the question if the bottom is in (I don't think so) and should everyone be buying this dip. Remember, bear market rallies are the most fearsome of all, so a short, sharp rise is not unusual, nor would it necessarily signal that the future is that bright. Naturally, US futures are also firmer, around 1.0% or so across the major indices.

Meanwhile, bond prices are softer with yields rising as concerns over risk diminish. Treasuries (+3.3bps) are the best performer of the day, falling only 9 ticks, while in Europe Bunds (+7.4bps), OATs (+8.0bps) and Gilts (+3.6bps) are all falling more aggressively. And worst of all is Italy (+9.7bps) as the domestic situation there is in turmoil after Signor Draghi resigned but President Mattarella refused to accept the resignation and now Draghi will explain his views and demands on Wednesday. In the meantime, amidst great political machinations, nobody has any idea what will come next. Remember, too, that the spread between Bunds and BTPs, now 216bps, is the key variable in the anti-fragmentation discussion. Above 200 is cause for concern. Above 250 is likely a catalyst for the ECB's new tool to be unveiled. We shall see.

In the commodity market, oil (+1.8%) is rebounding as the results of President Biden's Saudi trip were, at best, inconclusive and seemed to have accomplished exactly nothing with respect to getting a commitment by the Saudis to increase production. NatGas (+2.4%) is soaring as heatwaves around the world (>100° F expected in the UK) are driving up demand for electricity and NatGas remains the power source of choice there. But metals markets (Au +0.5%, Cu +2.3%, Al +1.4%) are all firmer on the back of this brighter outlook, and food prices are rising as well.

Finally, it should be no surprise that the dollar is softer this morning as with fear in abatement, as well as a growing belief the Fed has done its job and the market has already found the top in interest rates, owning the safest currency haven is no longer seen as necessary. So, in the G10, GBP (+1.0%) and SEK (+1.0%) are leading the way, but the euro (+0.7%) is also performing quite well. There has been precious little idiosyncratic data to drive things, so this is the broad dollar weakness across the board. Meanwhile, in EMG currencies, PLN (+0.9%), RON (+0.8%) and CZK (+0.7%) lead the way higher, again on a broad wave of dollar weakness. Interestingly, Poland is the only country in the EU that seems to be able to weather a Russian gas shutoff as they import all their gas from Norway. There is one notable loser in this space, TRY (-2.0%), which seems to be responding to a dramatic decline in the budget deficit there.

There is not much in the way of data this week, and of course no Fed speakers.

Tuesday	Housing Starts	1580K
	Building Permits	1650K
Wednesday	Existing Home Sales	5.37M
Thursday	Initial Claims	240K
	Continuing Claims	1343K
	Philly Fed	0.0
	Leading Indicators	-0.5%
Friday	Flash PMI Mfg	52.0
	Flash PMI Services	52.5

Source: Bloomberg

We do have two central bank meetings with the ECB (exp 0.25% hike) on Thursday following the BOJ (no change expected) from the night before. Given the widespread expectation of that 25bp hike by the ECB, most eyes will be on the nature of the anti-fragmentation tool.

Between now and the ECB, most attention will be paid to Q2 earnings releases, as we enter earnings season. There is much discussion as to whether or not current estimates are reasonable, especially given the prospects for a recession in the not too distant future. As long as investors wear their rose-colored glasses, look for the dollar to reverse some of its recent gains. However, this appears to be a short-term phenomenon, not a long-term change of view. That still points to a higher dollar.

Good luck and stay safe
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