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SMBC Capital Markets, Inc.

fxPoetry

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What They Fear

The Fed made it blatantly clear
That 'flation is still what they fear
The Minutes explained
That fifty's ingrained
At least 'til the autumn this year

Meanwhile out of China we learned
That President Xi is concerned
'Bout growth in Q2
Which when it comes through
Could well show 'neath zero they've earned

Much has been written about the FOMC Minutes which were released yesterday afternoon, but I would argue that very little from the Minutes was new news. After all, while it used to be the case that the Minutes would provide some insight into the discussions at the FOMC meetings, lately, Fed speakers are so keen to tell us their views that they seemingly never shut up once the FOMC meeting has ended and Chairman Powell has concluded his press conference. For instance, in the 3 weeks between the FOMC meeting and the release of the Minutes, we heard from 14 Fed speakers across 24 different venues. And remember, the other 3 Fed seats were not yet filled permanently, so there really were only 14 eligible speakers. And each one was eager to tell us their view explicitly. So, the fact that the Minutes explained that the committee expected fifty basis point rate hikes over the next two meetings was already widely known and priced in by the futures markets. Perhaps the only thing from the Minutes that may not have been clear before their release was the idea that the FOMC sees the risks to inflation as being to the upside while the risks to growth are for a lower outcome. I would argue we all knew that already, but perhaps seeing it published was news.

Proof that the Minutes are losing their luster as an important source of information is that upon their release, the market response was essentially nil across stocks, bonds and currencies. Perhaps this is a desired outcome as the nonstop information flow from Fed logorrhea is absorbed by market participants in small bits and thus prevents larger dislocations upon the release of some

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long-awaited data point. While we still have several of those on a regular basis, notably payrolls and the FOMC meeting and press conference itself, I would argue less opportunities for dislocation is a net positive for the workings of markets.

Summing up, it appears that the Fed is quite comfortable with current market pricing of their anticipated future activities. The big wildcard remains the balance sheet reduction which may, or may not, have an outsized impact on market liquidity across any and all markets, and therefore offers the potential for increased volatility as well as potential U-turns by the Fed if something breaks unexpectedly. However, until that begins next week, and arguably has run for a little while, we are unlikely to really know very much.

Of more interest to markets this morning, I would contend, was a speech given by Chinese Premier Li Keqiang, where he basically told an audience, albeit not on the record, that there was concern Q2 GDP growth could be negative and that it was critical that local officials better balance Covid controls and economic growth. (Not for nothing, but if you thought the Fed's dual mandate was tough to achieve, I would argue this is infinitely tougher, and the potential punishment for failing is arguably far, far greater.) Li highlighted a number of areas of concern including rising unemployment, management of local finances, inflation, and energy production, all of which must be kept on track in order to prevent much bigger problems. And while nobody would argue against those issues being critical to maintaining a strong economy, it doesn't appear that Li gave any suggestions on how to achieve these objectives, just that they must be achieved.

Covid-zero policy continues to be an anchor on the Chinese economy and as long as it remains in place it seems clear that China is not going to be performing as it has done in the past. Adding this policy to the growing trend of deglobalization and things have the opportunity to deteriorate more decisively in China over time. Remember, this is a nation that is aging rapidly and whose population is going to be shrinking over the coming decades. It is also the first nation that has aged before it reached a Western level of total wealth, so it is not clear how that will play out over time. After all, if the dependency ratio continues to decline, who is going to pay for the aging population? Certainly, that is a longer-term issue, but one that cannot be completely ignored. However, in the short term, the market continues to look at the renminbi and see funds exiting the country, not entering. Last night, CNY (-0.5%) was amongst the worst performers in the EMG bloc. I maintain my view that a move toward 7.20 is in the cards.

And what about the rest of markets? Well, Asian equity markets were mixed (Nikkei -0.3%, Hang Seng -0.3%, Shanghai +0.5%) while European markets are a touch firmer this morning (DAX +0.35%, CAC +0.5%, FTSE 100 0.0%) after surprisingly better than expected Italian Confidence data. US futures are a touch higher as well after a reasonable performance yesterday in the equity markets.

Bonds are mostly rallying with yields declining in Treasuries (-1.1bps), Bunds (-0.9bps) and OATs (-2.4bps). Gilts (+2.0bps) are bucking the trend, although there has been no data to drive that, but the real stars today have been the PIGS where yields are down between 4.7bps (Spain) and 7.9bps (Italy). I guess that all the recent commentary regarding rate hikes has seemingly suppressed any discussion of QT, and QT is going to be the big problem for the PIGS.

On the commodity front, oil (+0.8%) retains its bid tone although also remains within its recent range. NatGas (+1.4%) continues to climb and shows no signs of stopping. One of the interesting things about this is this price action is completely overwhelming the historic seasonality in pricing.

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Metals markets are mixed, but mostly lower with gold (-0.5%) and copper (-0.75%) softer though aluminum (+0.3%) has found some support.

Finally, the dollar is on its back foot this morning after a solid rally yesterday. GBP (+0.35%) and EUR (+0.3%) are leading the way higher in the G10, apparently on the view that the ECB is going to maintain its hawkishness and the BOE is going to find its backbone. The EMG bloc was a bit more mixed though. While the CE4 has followed the euro's lead (HUF +0.8%, CZK +0.4%) we saw some weakness overnight in Asia beyond CNY (-0.5%) with KRW (-0.25%) sliding despite a BOK rate hike of 25bps and hawkish commentary from the Governor. The rest of the APAC bloc was down by very small amounts in general, with very little new news to discuss.

We do get some data this morning with Initial (exp 215K) and Continuing (1310K) Claims as usual on a Thursday, but also the second look at Q1 GDP (exp -1.3%). At 11:00 we also see the KC Fed Manufacturing Index (18) which will be quite interesting given how weak the previous three regional indices have been. If this disappoints, we might have to consider that a trend is forming. On the Fed front, Vice-Chair Brainerd will be discussing digital assets at the House today, which may result in some economic comments depending on the Q&A. We shall see.

I don't believe anything has changed with respect to the big picture at this point. The market is pricing in a lot of Fed tightening and the FX markets are on board with that already. To my eye, the next big movement will only come when something about that policy changes. If hawkishness continues to dominate, the dollar can certainly continue its broader rally. However, if (when) the Fed blinks, be prepared for a reversal.

Good luck and stay safe
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