SMBC Capital Markets, Inc.

July 27, 2022

Andrew Fately
Executive Director, Senior FX Marketer
Global Markets Marketing Department
andrew_fately@smbcgroup.com
Direct: +1 212-224-4532
Representative: SMBC Capital Markets, Inc.

Future Pains

What **if '** Chairman Powell explains
A great deal of work still remains
To tame high inflation
And so, his narration
Describes models of future pains?

The first thing he's likely to say
Is though markets were right today
What's currently priced
Is not my zeitgeist
So, more tightness is on the way

I had a conversation with one of my very sharp and switched-on clients yesterday who raised a very interesting point. What, he asked, if the market is underpricing future Fed rate policy and simultaneously overpricing future ECB rate policy? What would happen to the euro then? Subsequently, I read a post from another very smart writer (@FedGuy12), someone who spent a dozen years actually implementing Fed monetary policy on the NY Fed's market desk, and he made a similar point. Essentially, he explained that by the Fed funds futures market pricing in a Fed pivot so soon, they are actually loosening policy, diametrically opposed to what the Fed is trying to do. Up until now, Chairman Powell has been quite clear that fighting inflation remains job #1 at the Eccles Building and so tightening policy further is what is required. The upshot is that the Fed may feel it has to tighten even further to change the market's views and help achieve sufficient demand destruction to bring down the rate of inflation.

And so, let us consider, for a moment, how that might play out and what it might mean for markets. There is very clearly a consensus that the Fed will tighten a few more times this year, but that by Q4, at the latest, when the economy is in recession, the Fed will reverse course despite still high inflation. I know that I have been in that camp based on the history of the past 40 years of Fed activity, and in truth, except for the Volcker years, arguably the past 80 years of Fed history, since WWII ended. Many pooh-poohed the idea that Powell is Volcker redux based on his actions in

The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.

This presentation has been prepared by Sumitomo Mitsui Banking Corporation ("SMBC") for informational purposes only and is being furnished by SMBC solely for use by the recipient. It is intended for discussion purposes only and does not constitute a commitment by SMBC to arrange or otherwise effect or enter into any transaction detailed in the presentation. This is not intended as a recommendation that you or any other person enter into any transaction. All information, structures, suggestions, and numbers used in the presentation are purely indicative. SMBC makes no representation or warranty as to the accuracy or completeness of any information presented herein and shall have no liability for any representations (expressed or implied) contained herein. The recipient of this material agrees not to divulge to or discuss with anyone other than SMBC the contents of this document without the prior consent of SMBC. Until agreed otherwise, this document shall be treated as confidential. Prior to participating in any transaction described herein, you should consult your own independent, legal, tax, accounting and other professional advisors.

2018 as well as the length of time he delayed the start of the current tightening cycle. But…what if?

At the last press conference, Powell very clearly highlighted headline CPI as something the Fed is watching carefully despite the fact their models (which have been useless) utilize core PCE as an input. Looking at the next three months' comps, which are 0.5, 0.3 and 0.4 respectively for July through September, it won't be very difficult to see higher M/M prints upcoming which means higher Y/Y headline CPI prints. This is true despite the fact that oil prices have eased off somewhat. Given this fact pattern, and Powell's clearly stated goal of crushing inflation, it is quite possible that the Fed continues to raise rates at a quicker pace and far longer than currently priced by the futures market. How about this pattern? 75bps today, hawkish talk at Jackson Hole, 50bps in September, November and December? That would take Fed funds to 4.0% by the end of the year, would have a dramatic impact on markets and probably insure a recession. But it would also likely help reduce inflationary pressures pretty substantially. All the way to 2.0%? I doubt it, that ship is long gone, but 3.5% - 4.0% seems like a possibility.

A brief word on the ECB side of the equation before we move on. There is NO way the ECB raises rates as far as the market is currently pricing. The problems on the continent go from bad to worse daily regarding the energy situation and the impact on the Eurozone economy is shaping up to be devastating. At this point, if Russia shuts off the gas before the end of the summer, we may have seen the last hike already.

Now, back to our regularly scheduled Fed discussion. A Fed that behaves in that manner, will have a very significant market impact. Equity markets are likely to find that the strike price of the Fed put is MUCH lower than currently estimated, perhaps at 2000 for the S&P 500 with similar declines in the other major indices. Treasury yields are likely to remain quite inverted as the long end of the curve responds to both the upcoming recession as well as the growing belief that the Fed really is going to fight inflation, while the short end of the curve will follow Fed funds higher. Currently the 2yr-10yr inversion is 26 basis points. While it hasn't been larger than this level since 2000, when it reached 42bps, going back in time it inverted 200 basis points in 1980, not coincidentally, the time of Chairman Paul Volcker. The point is it can invert far more than its current level. And the dollar? Well, that last inversion was the beginning of a massive USD rally that culminated in 1985 and the Plaza Accord to halt that move. Whither EURUSD in this situation? Testing record lows at 0.82 is not out of the question. Not this year, but sometime in H1 2023 if it plays out.

Now, all this is just another hypothetical based on what different people think the Fed's reaction function will be and then trying to estimate future market movements based on our observation of past movements. But in reality, we have no idea, which is why hedging is so important. While this is not my baseline case, I think it fits within the panoply of possible outcomes.

Ok, ahead of the Fed, what is happening? Asian equity markets were mixed (Nikkei +0.2%, Hang Seng -1.1%, Shanghai 0.0%) although European bourses are in the green (DAX +0.2%, CAC +0.4%, FTSE 100 +0.6%) and US futures are all pointing higher on the back of better forecasts for a couple of megacap tech names despite modest earnings reports.

Treasury yields are lower by 1.5bps, but in Europe, things are a bit gloomier as Bunds (+3.9bps), OATs (+4.1bps) and gilts (+5.3bps) all sell off, albeit not as much as Italian BTPs (+11.6bps!) That all important Bund-BTP spread has moved back to 240 basis points, and it appears that EGB

The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.

This presentation has been prepared by Sumitomo Mitsui Banking Corporation ("SMBC") for informational purposes only and is being furnished by SMBC solely for use by the recipient. It is intended for discussion purposes only and does not constitute a commitment by SMBC to arrange or otherwise effect or enter into any transaction detailed in the presentation. This is not intended as a recommendation that you or any other person enter into any transaction. All information, structures, suggestions, and numbers used in the presentation are purely indicative. SMBC makes no representation or warranty as to the accuracy or completeness of any information presented herein and shall have no liability for any representations (expressed or implied) contained herein. The recipient of this material agrees not to divulge to or discuss with anyone other than SMBC the contents of this document without the prior consent of SMBC. Until agreed otherwise, this document shall be treated as confidential. Prior to participating in any transaction described herein, you should consult your own independent, legal, tax, accounting and other professional advisors.

investors are going to test Madame Lagarde and her TPI. Clearly, that is not what she was looking for.

Oil prices (+1.1%) have been climbing from earlier session lows despite news that Wuhan is locking down 1 million people and other areas within China are going through similar issues. Weak economic data has also not been enough to undermine crude today as the structural shortage of the sticky black stuff remains a critical issue. NatGas (+0.1% in US, +0.7% in Europe) has backed off earlier session highs when European gas was higher by more than 10%. But any decline here is merely transitory until the Russia/Ukraine situation resolves. Metals are mixed (Au +0.25%, Cu +1.1%, Al -0.45%) but food continues to rebound from its early summer sell-off.

Finally, the dollar is on its heels today, weaker vs. every G10 currency led by NOK (+1.1%) and EUR (+0.5%). Contrary to my views above, the market appears to be covering shorts ahead of the FOMC meeting which will, obviously, have a huge impact. As to the EMG bloc, the news is more mixed with the CE4 currencies all gaining on the back of the euro's strength, while some APAC currencies suffered (PHP -0.7%, KRW -0.4%) on fears of weakening global growth and outflows from local stock markets.

Ahead of the Fed, we see some inventory data (Wholesale exp 1.5%, Retail 1.0%) as well as Durable Goods (-0.4%, 0.2% ex transport) but really, all eyes are on the FOMC statement at 2:00pm and then Powell's presser at 2:30. Until then, a little choppiness is likely, and this is a day where there is a chance for a true reevaluation of the narrative. We shall see.

Good luck and stay safe
Adf

The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.

This presentation has been prepared by Sumitomo Mitsui Banking Corporation ("SMBC") for informational purposes only and is being furnished by SMBC solely for use by the recipient. It is intended for discussion purposes only and does not constitute a commitment by SMBC to arrange or otherwise effect or enter into any transaction detailed in the presentation. This is not intended as a recommendation that you or any other person enter into any transaction. All information, structures, suggestions, and numbers used in the presentation are purely indicative. SMBC makes no representation or warranty as to the accuracy or completeness of any information presented herein and shall have no liability for any representations (expressed or implied) contained herein. The recipient of this material agrees not to divulge to or discuss with anyone other than SMBC the contents of this document without the prior consent of SMBC. Until agreed otherwise, this document shall be treated as confidential. Prior to participating in any transaction described herein, you should consult your own independent, legal, tax, accounting and other professional advisors.