SMBC Capital Markets, Inc.

fxPoetry

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Late Summer Swoon

The cat's been let out of the bag
As insider tongues all now wag
Come Thursday we'll see
Lagarde's ECB
Hike fifty, though growth there may lag

But traders are over the moon
As unlike the dog days of June
The euro's on fire
And keeps rising higher
Though watch for a late summer swoon

As we approach this week's ECB meeting on Thursday, many market participants, across different sectors, have started to focus on just what the ECB will do. To date, they have been woefully behind the curve, even more so than the Fed, as CPI in the Eurozone is running at 8.6%, which was confirmed with this morning's final June reading. Obviously, that is far higher than the ECB's 2.0% target, and yet, right now, the base deposit rate remains unchanged at -0.50%. Now, they have ended all of their asset purchase programs, but continue to reinvest all the proceeds of maturing securities. (As an aside, despite the fact the ECB is not yet focusing on reducing the balance sheet's size, it has actually shrunk more than the Fed's since the Fed ostensibly began QT. Of course, neither has moved much with the ECB smaller by 0.7% while the Fed has seen assets fall by just $20 billion or 0.2% of the balance sheet since the beginning of QT.) At the last ECB meeting, Madame Lagarde guided us into believing that a 25-basis point hike would be appropriate in July with the potential for more in September. However, the more hawkish members of the committee, notably Austria's Holtzmann and Latvia's Kazaks, have been aggressively calling for 50, and it appears that view is gaining some sympathy elsewhere on the committee.

The problem for the ECB is that the things that are driving inflation in Europe, notably energy prices, are not going to be impacted by a rate hike. If Russia were to keep the NatGas taps closed and energy prices rose further, higher interest rates would not solve the problem. In fact, they would only exacerbate the situation as slowing economic activity would lead toward layoffs and more economic stress on the average individual in Europe, while doing nothing to lower energy prices. However, as with central bankers everywhere in the world, the deep-seated belief that they need to do something in response to inflation, whether or not it will be effective, is quite strong and almost impossible to overcome.

This begs the question; will they hike by 50? Certainly, the FX market believes so, at least based on the fact that the euro is higher by a further 1.1% this morning and now a solid 3% off the sub-parity lows seen just last Thursday. Arguably, there is a great deal of short covering attached to this movement, but the catalyst seems likely to be the strengthening of the 50-basis point narrative. Now, if one were to look at the data from the Eurozone, it does not make for a pretty picture. Perhaps the succinct way to view it is the Citi Surprise Index which shows how actual data is behaving compared to the forecasts preceding its release. That number, currently -52.6, speaks to the disappointing economic activity as most countries in the Eurozone suffer from the combination of higher energy prices and weakening export activity due to slowing global activity. As an example, Germany is currently running a trade deficit, as are most Eurozone nations, despite the euro's weakness. In other words, times are tough all over.

With that in mind, can the ECB really address inflation as aggressively as they need to? As of this morning, the OIS market has priced only a 50% probability of a 50-basis point rate hike. If that probability moves higher, above 75%, before Thursday, I believe the ECB will feel empowered to raise rates more aggressively as the market would be expecting it. But if we remain at current pricing, it would be far more surprising to see that type of move. As to the single currency, while the 50bp narrative is active, it probably has a bit further to run. But beware a buy the rumor, sell the news type of outcome, even if they do hike 50. While I wouldn't rule out a move back toward 1.05, I would also be an active hedger if we see it as I don't believe it would be long-lasting.

OK, let's look at this morning's price action. Equity markets have been mixed after yesterday's afternoon decline in the US. The Nikkei (+0.65%) was the best performer by far as the Hang Seng (-0.9%) suffered on the tech selloff and Shanghai (0.0%) couldn't make up its mind. In Europe, the DAX (+0.1%) and FTSE 100 (+0.2%) have edged higher while the CAC (0.0%) is leaning ever so slightly softer. US futures, though, are all in the green by between 0.7% and 1.0%. With the bank earnings out of the way, investors will be focusing on tech company earnings coming up.

Turning to the bond market, Treasuries are ever so slightly higher with the 10-year yield lower by just 0.6bps. Bunds (+3.2bps) are today's underperformer while OATs (+0.8bps) are not faring quite as poorly, nor are BTPs (+1.0bp), so that fragmentation spread is actually narrowing slightly. Gilts (-4.7bps), though, are today's winner despite (because of?) stronger than expected employment data released this morning.

Oil prices (-2.0%) are giving up part of yesterday's gains after comments from Saudi Arabia explained there's plenty of oil around, just a lack of refining capacity to convert it into a usable form. I would expect that crack spreads might widen on that, but in fact, product prices are falling faster. NatGas (-2.0%) is also under pressure but all eyes in that market remain on Thursday when the NordStream 1 pipeline is scheduled to be reopened. As to metals markets, gold (+0.5%) is benefitting from the weaker dollar while copper (-1.0%) and aluminum (-0.4%) are both under pressure on the slowing economic story.

Finally, as mentioned above, the dollar is under pressure everywhere this morning with NOK (+1.7%) the G10 leader despite oil's decline, although we are seeing similar gains in SEK and AUD (+1.25%) and NZD (+1.25%) have both benefitted from the RBA Minutes which were perceived as more hawkish than not. Even JPY (+0.5%) is gaining as it seems there is a growing schism in the market between the Japanese, who believe that there is much further for JPY to weaken, while many international investors are starting to feel like the move is finished. Until the BOJ changes its policy, it is hard to see a much stronger yen, although that's not to say it will weaken further either. We may simply be at a new equilibrium until the next policy adjustment.

As to the emerging markets, only TRY (-0.65%) has been unable to take advantage of the dollar's weakness as the country's fundamental problems are too great to overcome. But everything else is firmer led by HUF (+2.1%) and PLN (+2.1%), with the forint benefitting from continued austerity measures seen as economically positive while the zloty seems incongruously higher despite comments about less policy tightening going forward from one of the MPC members there. However, this is really a dollar weakening day, so this is all shades of gray.

On the data front, Housing Starts (exp 1580K) and Building Permits (1650K) are on the docket, and both will be carefully watched as the anecdotes about a crumbling real estate market are starting to become more widespread with talk of price cuts and deal failures. As we are in the Fed's quiet period, there are no speakers today to consider.

Clearly, there is momentum for the dollar to continue this softness, but I do not believe it is a long-term situation, at least not until we see some policy changes. When the Fed categorically blinks, or if somehow the ECB or BOE become hyper aggressively hawkish, we can discuss the dollar turning lower in the long run. But for now, I think this dollar sell-off is ripe to be faded and hedgers should be looking for spots to add.

Good luck and stay safe
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