SMBC Capital Markets, Inc.

fxPoetry

August 24, 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.

His Current White Whale

If more oil flows from Iran
Then OPEC has got a new plan
Their output will shrink
So prices don't sink
As flames of inflation they fan

Aside from the energy tale
The topic of choice, without fail
Is will Chairman Jay
Go more than halfway
In fighting his current White Whale?

Oil prices continue to grind higher despite the news earlier this week that the JCPOA (Iran nuclear deal) had cleared another hurdle as Iran ostensibly dropped a red line requirement and was closer to being signed. When this headline first hit, oil fell sharply, about $4/bbl, as traders assumed that more supply would be hitting the market. But while there has been no further news on that front, the Saudis were quick to respond by saying OPEC+ would likely reduce supplies in order to offset any additional volume from Iran, thus supporting prices. Remember, too, that OPEC+ has not actually achieved their production targets (no longer called quotas) in quite a while, with actual production running some 2 million barrels per day under those targets. This has led to many questions about just how much spare capacity may exist within OPEC and is part of the long-term prognosis of a structural shortage of supply. At any rate, that decline in prices was quite short-lived and this morning we are back pushing $95/bbl, the highest price in 3 weeks.

With the inflation story still front and center worldwide, the fact that the Saudis and OPEC are willing to restrict supply further means that many of the hopes of inflation having peaked may soon be called into question. Remember, the key reason US headline CPI fell last month was the decline in gasoline prices. If gas prices head back up, so too will inflation.

Aside from this story though, traders and investors have fully turned their attention to the Jackson Hole Symposium that starts tomorrow, but especially to Friday morning's speech by Chairman

Powell. Yesterday afternoon, we heard from the last scheduled Fed speaker before the symposium, Neel Kashkari, who said, *"it's very clear we need to tighten monetary policy to bring things into balance*." He added, "*So with inflation this high, for me, I'm in the mode of we need to err on making sure were getting inflation down, and only relax when we see* ***compelling evidence*** *that inflation is well on its way back down to 2%."* [emphasis added] What is "compelling evidence?" He never defined that, nor would I expect he would, but I'm pretty confident it is more than 2 months of CPI prints not making new highs.

And this is why Powell's speech is so important. The current hope is that he will lay out the framework the Fed is using to consider their future policy choices. Some questions that are hoping to be answered are: is there a level of inflation, or a trajectory, that will indicate "compelling evidence" things are moving in the right direction sufficiently to pause the hiking cycle? What about unemployment, is there a level that is too high for comfort? What other indicators are seen as key to the decision-making process?

Alas, I fear we are all in for a disappointment as I doubt any of that information will be forthcoming. Consider that at the press conference in July, Chairman Powell indicated he thought the current level of Fed funds represented the 'neutral rate' and he has been raked over the coals about that ever since. In fact, a number of FOMC members have come out with higher estimates of the neutral rate since then. The point is, I think Powell will be quite circumspect when it comes to giving any hard information on the subject and speak in broad generalities about inflation continuing to be too high, about how important it is to ensure that inflation expectations don't become unanchored and that the FOMC is prepared to do whatever is necessary to achieve their goals. I expect this will be quite the nothingburger.

In the meantime, we have two full sessions before we get there. Yesterday saw more modest equity weakness and after much weaker than expected US data (PMI's, Richmond Fed and New Home Sales all printed far below expectations), the dollar saw some consolidation of its recent moves. This morning, however, risk is once again under a bit of pressure and the dollar seems to be edging higher again.

In Asia, it was almost entirely red (Nikkei -0.5%, Hang Seng -1.2%, Shanghai -1.9%) although Australia (+0.5%) managed to buck the trend. Europe (DAX -0.2%, CAC -0.1%, FTSE 100 -0.5%) are all edging lower as are US futures at this hour, which are all softer by about -0.1%. There has been virtually no data from Europe this morning, so these movements seem to be position adjustments ahead of the bigger news later this week.

While Treasuries are little changed this morning with the 10yr at 3.04%, we are seeing a bit of bond selling in Europe with all the major markets showing higher yields. Gilts (+5.2bps) are the worst performer followed by OATs (+5.0bps) then BTPs (+4.6bps) and finally Bunds (+3.7bps). That Bund-BTP spread continues to widen which means the ECB remains on edge. There is growing talk that the ECB may raise rates by 75bps in September, although it is not clear how that can be accomplished with Italian BTPs under so much pressure and the Italian government still not formed.

The rest of the commodity complex shows NatGas (+1.2%) rebounding after yesterday's decline on news that the Freeport LNG terminal would not reopen until November, rather than the previously expected October opening. The idea here is that reduced exports mean greater supply in the US and therefore lower prices. But in Europe (+5.0%), the story is one of growing concern over the NordStream 1 pipeline and if it will ever be reopened. Gold, after a nice rebound yesterday is lower by just -0.1%, while copper (-1.5%) has softened on the ongoing weakness in Chinese economic activity due to the dramatic heatwave through which that nation is suffering and the substantial reductions in electricity production that have accompanied it.

Finally, a look at the dollar shows it is broadly stronger again, with NZD (-0.6%) the G10 laggard followed by AUD (-0.45%) and GBP (-0.45%) as all three seem to be seen as targets for further declines amid broad dollar strength. Short positions seem to be building in these currencies. On the flip side, NOK (+0.2%) is the leading gainer, following oil's rebound.

In the EMG space, CNY (-0.5%) is actually the worst performer today, a very unusual situation, as concerns grow over the economic situation there with the combination of Covid zero policy and the heat wave slowing the economy. It seems increasingly clear that the PBOC is quite comfortable with a weaker renminbi at this point. Beyond that, the CE4 has seen weakness of between -0.3% and -0.4% as they track the euro's -0.4% decline. On the plus side, KRW (+0.25%) is tops as traders prepare for the BOK's meeting this evening and an expected 25bp rate hike, although there are those expecting 50bps.

Data here this morning brings Durable Goods (exp 0.8%, 0.2% ex transport) and that's it. And there are no Fed speakers on the docket, so today's market will be headline watching with the FX market taking its cues from stocks and bonds. Given the dollar has recouped essentially all its losses from the weak data yesterday, I expect at least one effort to break to new lows for the move below 0.9900.

Good luck and stay safe
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