SMBC Capital Markets, Inc.

fxPoetry

September 15, 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.

The Previous Plan

In Europe as well as Japan
They're finding the previous plan
Of exporting more
Than they brought onshore
Has changed in a very short span

Now deficits are all they see
In trade, which is no longer free
Their moneys have slumped
As traders have jumped
To dollars, while stocks they all flee

A little discussed impact of the current dramatic rise in the price of energy has been the effect on trade accounts around the world. While we frequently hear about the size of the US trade deficit, and it is shockingly large, a tacit part of that discussion is the comparison with Europe and Japan where they (used to) run trade surpluses. In fact, that was a key goal of the previous administration and the raison d'etre for the tariffs on Chinese goods. But a funny thing happened when Russia invaded Ukraine and shocked energy markets around the world; Europe and Japan turned from surplus to deficit nations. In fact, both Japan (Trade deficit -¥2.8 trillion in August) and the Eurozone (trade deficit -€40.3 billion in July) are currently running the largest monthly deficits in their respective histories.

Consider this issue when thinking about the long-term valuation of the dollar. Dollar bears routinely point to the fact that the US runs large and consistent budget, current account and trade deficits as a rationale for the dollar to decline. After all, that is what the textbooks tell us should happen ceteris paribus. Of course, ceteris is never paribus and so the dollar tends to find its valuation based on many other metrics. But given the length of time that both Europe and Japan were surplus nations on these measures, that was always an underlying factor in currency markets.

However, that is no longer the case, and quite frankly, may never be the case again, certainly not for Japan, which has essentially zero natural resources on which to draw domestically, but likely even Europe, which has resources but has crafted a series of energy policies seemingly designed to encourage economic weakness and reliance on others. We can never forget that energy is life, and access to abundant and cheap energy has been critical for building our current civilization. Starving ourselves of these resources, for whatever reason, will only diminish growth capacity and result in a poorer world overall. Remember, in the contest between physics and platitudes, physics is undefeated.

With this as a backdrop, it is a bit easier to understand the dollar's recent performance. The US, after all, is an energy exporter. And while oil prices (-0.7% today) remain linked to global markets, the same is not true for natural gas (-5.3%) or electricity. A great example of the upcoming problems that have the potential to occur this winter is the following: the UK energy plan is to supplement their electricity supply by importing whatever they cannot produce domestically from France, while the French plan, is to supplement whatever electricity they cannot produce by importing it from the UK. You cannot make this stuff up! Obviously, both these scenarios cannot occur simultaneously, and the conclusion to be drawn is that the winter is going to be quite difficult in both the UK and France. Once again, if you are wondering why the euro and the pound have been so weak, and why their prospects continue to be dire, you need look no further than this to understand the policy mistakes that are undermining both.

With that as introduction, let's start with the FX markets today. In the G10, only the Swiss franc (+0.65%) has outperformed the dollar, seemingly as an even safer haven than the buck, while the rest of the bloc remains under pressure led by NOK (-0.4%) and AUD (-0.3%). While these moves are nothing like we saw Tuesday, the trend higher in the dollar remains quite strong. And despite further intervention chatter overnight from Tokyo, the yen (-0.25%) seems to be heading back to the 145 level yet again. In the emerging markets, the picture is the same, with the dollar rallying against virtually every currency, notably vs. the offshore CNH (-0.5%) which is now trading above 7.00 for the first time in a bit more than 2 years. But the dollar's strength is broad based with HUF (-0.45%), THB (-0.45%) and MXN (-0.4%) showing that every region in the world is suffering. As long as the Fed continues to be seen as the most hawkish of the major central banks, this will continue.

Turning to equities, the risk picture is a bit less clear. Asia overnight (Nikkei +0.2%, Hang Seng +0.4%, Shanghai -1.2%) was mixed with China suffering on downgrades by numerous analysts of the Chinese economic picture. Europe (DAX -0.1%, CAC -0.4%, FTSE 100 +0.25%) is also mixed although certainly, the movements have not been that large in either direction. We continue to hear from ECB members, and most are maintaining their recent hawkishness calling for more large rate hikes to address the runaway inflation ongoing there. The market, though, is still not overly impressed and will need to see actual rate hikes to change their view. Words will not be enough this time around. Meanwhile, US futures have been knocking around unchanged all evening and are currently -0.2% across the board. Certainly, the idea of a bounce after Tuesday's rout has not really come about.

Treasury yields (+4.3bps) continue to climb and are now just below the peak of 3.49% seen in June. With the curve still inverted, 2yr yields are above 3.8% and look like they will be moving above 4% soon enough. My take is if the Fed does raise rates 100bps next week we will see that in a hurry. In Europe, yields are also edging higher (Bunds +3.1bps, OATs +1.2bps, Gilts +1.9bps, BTPs +3.5bps) as concerns remain over European (and UK) energy and economic policies.

Certainly, the announced price caps and windfall taxes in Europe did not inspire any confidence. Meanwhile, JGBs are right at their 0.25% cap, and the BOJ continues to oblige and buy them all.

Beyond the energy markets, gold (-0.6%) continues to suffer on higher nominal and real US rates as well as the strong dollar, and copper (-1.0%) seems to be indicating a downbeat look at the economy going forward. Interestingly, aluminum prices are rising (+0.5%) but I believe that is more of a supply restriction issue as yet another Chinese aluminum smelter is reducing production due to the high electricity prices.

On the data front, as well as the weekly Initial (exp 227K) and Continuing (1478K) Claims data, we see Empire Manufacturing (-12.9), Philly Fed (2.3) and Retail Sales (-0.1%, 0.0% ex autos) at 8:30 and then IP (0.0%) and Capacity Utilization (80.2%) at 9:15. If we see strength in Retail Sales, I expect that will be seen as yet another reason for the Fed to be even more aggressive going forward with all the negative consequences for risk assets that entails.

The dollar story remains one of higher for longer until the Fed blinks. Right now, Powell is winning the staring contest, so look for the dollar to continue to rise going forward.

Good luck and stay safe
Adf