SMBC Capital Markets, Inc.

fxPoetry

August 2, 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.

Ill-Conceived

All eyes today are on Taipei
Where Nancy is soon set to stay
The Chinese are peeved
At this ill-conceived
Event, and have warned of doomsday

The market response has been clear
As traders expressed growing fear
With stocks in the red
To dollars they've fled
And havens are suddenly dear

The question of the hour is, does it really matter? Speaker of the House, Nancy Pelosi, is widely expected to stop by Taipei on her swing through Asia this week and sit down with Taiwan's president, Tsai Ing-wen. It can be no surprise given China's stance that Taiwan is simply a rogue province and actually part of China, that a major US political figure heading there to speak to their president has raised Chinese ire. There has certainly been a great deal of bluster around the visit with China threatening all types of consequences and displaying their military readiness for action. But will they actually consider starting a major conflict with the US because a politician visited an island over which they claim ownership, but whose people disagree on that status? Perhaps, but it seems unlikely.

However, given the ongoing implosion in the Chinese property market and the negative impact that is having on the Chinese economy, it is not hard to see that President Xi may see this as an opportunity to rally his increasingly disaffected population around him by highlighting threats to Chinese sovereignty. After all, the first chapter in the political playbook is if your ratings are falling, start a war. While this may seem simplistic, especially for a situation that seems to have so many political nuances and underpinnings, sometimes simple is best.

Consider what is happening in China's economy right now. Overall economic activity has been slumping (Q2 GDP -2.6% Q/Q, +0.4% Y/Y) with all the main data points under pressure including

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IP, Retail Sales and especially Property and Residential Investment. Manufacturing PMI data fell below 50 and has been trending down for the past 2 years post Covid. Meanwhile, the property market, which constitutes ~29% of China's economy is slowing rapidly as overlevered developers continue to fail. These failures have resulted in projects stopping and the ordinary citizens who took out mortgages on the unbuilt homes have stopped paying those mortgages, imperiling both the banks and the developers, and interestingly, many cities who use property sales as a key source of revenue.

How do we know there are problems there? This morning's Bloomberg headline says it all; ***Chinese Leaders Say GDP Goal is Guidance, Not a Hard Target.*** Riiigghhtt. Last year, I assure you it was a hard target. Of course, if you are a local official, this is good news, because there was a vanishingly small probability that any area could reach the official 5.5% target, let alone the country as a whole. The question is what will China do now? It seems their playbook consists of continuing to bail out banks and developers while allowing further softening in the renminbi. As long as President Xi continues with the zero covid policy, Chinese economic activity is destined to remain impaired. And remember, Xi has an important conclave coming up in October when he is seeking an unprecedented third term as President, so a cratering economy is something he desperately needs to avoid. From our little FX window on the world, I expect USDCNY(-0.25%) to continue to slowly rise regardless of how the dollar performs against anything else.

Arguably, that is the story that is setting the tone today. Risk is definitely 'off' as equity markets around the world are under pressure (Nikkei -1.4%, Hang Seng -2.4%, Shanghai -2.25%, DAX -0.9%, CAC -0.75%, FTSE 100 -0.25%) while government bonds have seen yields decline sharply representing haven demand. So, Treasuries (-2.7bps) continue their price rally and are now sitting at their lowest yield (2.55%) since April. But we have seen strong demand in Europe (Bunds -6.5bps, OATs -5.7bps, Gilts -6.9bps) as the Bund-BTP spread widens again, now to 226bps. Asia, too, saw government bond yields fall with JGBs (-1.5bps and down to 0.164%) showing that Kuroda-san has no problem maintaining YCC there. Australian bonds (-8.0bps) responded to the RBA last night which raised rates by 50bps, as expected, but seemed to sound dovish in doing so. At least that is how the market interpreted Governor Lowe's comments.

Does all this make sense though? After all, inflation readings have not yet rolled over in any meaningful manner and while energy prices are clearly off their highs, the prices of other things, notably labor, continue to make gains. Recall that too-high inflation has been the proximate cause for all the market ructions and equity and bond rallies only serve to ease financial conditions further. As most central banks are attempting to tighten financial conditions, the implication is they will have to tighten the policy that they control even further to achieve their goal of lowering the rate of inflation. The one thing that I don't see occurring is a soft landing of any sort. The premature market response to the worst is over seems destined to result in an even worse outcome for investors. Central banks around the world are in the process of deflating the largest asset bubble in history, one that took more than a decade to inflate. It will not be completed in 6 months of equity weakness.

Finally, can someone please explain to me why the euro remains above parity? I am hard-pressed to find a single positive aspect of the situation in Europe that would entice me to consider owning euro denominated assets. First off, natural gas prices in Europe are currently ~$62/mmBtu, nearly 8x the price in the US ($8.0/mmBtu). One-year forward electricity prices just rose to €400/MWh today, an all-time record and a price at which all German industry is no longer

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competitive in their markets. 40% of fertilizer production has been shuttered and this is with Russian gas still flowing, albeit at a greatly reduced rate. Meanwhile, the third largest economy is in the middle of a political crisis, with no government and fears that the election in late September will result in a more reactionary outcome. In France, President Macron has no ability to implement his desired policies as the National Assembly is not under his party's control. Finally, Germany's economic problems merely serve to highlight the inability of its government to effect any policy of note given their dependence on Russian energy and simultaneous animus to Russia over the Ukraine invasion. In other words, short of Russia retreating from Ukraine, there are no good medium-term outcomes for the continent. And while the situation in the US may not be great, it is not as dire as the European situation. The euro should be much lower in my estimation, and I believe it will get there. Be prepared.

Like hawks and eagles
The yen, too, has been soaring
When will it touch down?

One last thing, the yen (+0.5%). In less than a week, it has rallied more than 5% as US treasury yields have fallen sharply, and their spread over JGB's has collapsed. Combining the rate movement with the fact that the yen was the most heavily shorted currency has seen a significant number of stop-loss orders getting triggered. This morning we have made it to a 130 handle and technically, another 1-2 big figures seems quite realistic. The yen's weakness was always overdone, but as US yields powered higher, it was easy to explain. If we have, in fact, seen the top in Treasury yields, my take is we have also seen the top in USDJPY. However, I am not prepared to imply that the Treasury story has been completely written yet, so we need to watch carefully. In the moment, especially when a market is moving quickly, it is always difficult to keep perspective. But in this case, perspective is necessary. Consider your longer-term view of the US economy (I don't think anything is really going to change in Japan) and if you believe in the soft landing and Fed pivot, look for USDJPY to retrace the bulk of its gains this year. Personally, I'm not there yet.

Ok, the only data point today is JOLTS Job Openings (exp 11.0M) but we do have three Fed speakers, Mester, Evans and Bullard. Given the hawkishness from Kashkari over the weekend, it will be interesting to see if Evans, the affirmed dove, sounds his usual self or more like Kashkari. Listen closely as a hawkish outturn implies, to me at least, that the market is misinterpreting the Fed and this recent rally in equities will prove to be just a bear market trap. In that scenario, I like the dollar as well.

Good luck and stay safe
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