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Quaking

The seven and score EU nations
Are quaking down to their foundations
As energy prices
Explode into crises
And keep pushing up their inflations

Their policymakers are scared
So naturally they have declared
A policy change
Where they can arrange
Twas not **them** whose choices had erred

I think it is time to start to consider exactly how governments, specifically in the EU, but generally everywhere, are going to respond to the ongoing pressure from rising energy prices. While the first rule of politics is to blame somebody else, at some point, if a crisis is large enough, policy choices need to be made. With that in mind, yesterday, the EU declared an 'emergency' which allows the leadership to take decisions that may otherwise be illegal based on their current legal framework.

It seems that the best idea they have is to sever the link between natural gas prices and electricity prices, but because of the way they designed their electrical grids, that is a virtual impossibility. (Do not be smug because we have pretty much the same design in our electricity grids, so that problem could come close to home sooner than you think.) The structure in place is that the grid takes electricity from the cheapest source first and works its way up until it finds sufficient electricity to satisfy demand. But it pays all the providers the price of the highest cost electricity. A typical situation would be wind, then solar, which are cheapest at the margin though expensive overall, then coal and finally natural gas, which with the current shortages have become crazily expensive. But that means that all the electricity gets priced at the highest price, which as you may have seen is upwards of 10x the price seen here in the US.

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Not surprisingly, almost everybody in Europe, whether individuals or companies, are struggling to pay these bills. We have already seen the largest German utility, Uniper, go bankrupt and it is now operating only because of €14 billion of state aid. We have also seen half the aluminum smelting capacity in Europe shuttered because of the high cost of electricity, the main ingredient in its production, and there is quite the air of panic across all nations.

But politics is something that cannot be ignored, and the fact that this emergency has been officially declared means that the EU is going to come up with some type of system to try to reduce prices. Of course, the best way to do that would be to increase the supply of natural gas, but the Europeans have banned fracking and don't have enough LNG terminals to offset what they were getting from Russia via pipeline. As well, it appears that both the US and Canada, two major exporters of gas, seem to be growing uncomfortable selling their gas, given it might be needed at home soon, to the Europeans. So, Europe has real problems.

Alas, I expect that their 'solutions' will be one or a combination of the following: price caps, rationing, and/or subsidies for consumers. By definition, they will not do nothing, and beyond those ideas, really the only other thing they can do is cave to Vladimir Putin and remove sanctions and hope he turns the gas back on which is politically impossible at this time. The problem is that none of the first three options will have any long-lasting impact, although they may help the continent get through the winter. But price caps will result in shortages, rationing is merely organized shortages and subsidies will do nothing to reduce prices, but rather actually support them by maintaining demand.

With this in mind, it becomes increasingly difficult to get excited about Europe's financial markets or the euro. After all, if the economy is going into a recession, and likely a deep one, while inflation is rising sharply (CPI printed at 9.1% this morning, highest ever since the Eurozone came into existence) due to rocketing energy prices, what could possibly be attractive about the continent.

But all of this is widely known, which means that at least some part of this outcome is already built into current market prices. In fact, if we consider what we have learned in the past several days it is that the Fed has essentially promised to keep raising interest rates and maintain them at much higher levels than previously expected by the market, while the EU has declared an energy emergency which means that there is likely going to be more ECB stimulus to pay for things.

And so I ask, is it possible that the euro has actually bottomed? Because what is the next piece of news that is going to be more bearish for the single currency than what we already have seen? Markets are remarkable at anticipating future activity, and there is certainly a case to be made that the euro has already probed its lows. I only ask because in truth, it has held up remarkably well thus far.

One possible answer to the question of what could be worse for the euro (and Europe as a whole) is perhaps a very strong NFP number on Friday, >350K, followed by an August CPI outcome in the US, to be released on September 13th ahead of the FOMC meeting, that is back above 9.0%. To me, that combination feels like it could get the next leg of the dollar upmove started. But short of that, politicians will not simply allow markets to respond to supply and demand if doing so risks them losing their next election. They have a lot of smart folks in Europe and they may come up with something ingenious that will work, but I am skeptical. However, I am sure, in the same vein as the Transmission Protection Instrument, which is simply a fancy way of saying they will buy BTPs and sell Bunds, they will come up with some fancy name for their 'solution' although I

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suspect it will be a combination of rationing and subsidies. You can be sure, though, that the ECB will be all in and support it fully, and I suspect that if nothing else, we could see a temporary respite for the euro, if not a long-term reversal. This is just one man's view, but history tells us they will not sit idly by and allow the European economy to crumble. Be prepared.

With that diatribe out of the way, let me review markets this morning. Risk continues to be shed almost universally after the third consecutive down day in US equity markets yesterday. The Nikkei (-0.4%) and Shanghai (-0.8%) both retreated from early gains while the Hang Seng was essentially flat on the day, also ceding those early gains. In Europe, though, it is all red with the DAX (-0.75%), CAC (-1.0%) and FTSE 100 (-1.25%) unable to withstand the pressure of rapidly rising inflation and the concomitant interest rate hikes that continue to be expected. Again, this morning, we have heard from another ECB member (Bundesbanker Nagel) who is the 6th to imply that a 75bp hike next week is appropriate. But remember, there are 25 members to the ECB Council, so they need many more to carry the day. As to the US, the picture is mixed with NASDAQ futures gaining about 0.5% at this hour (6:30am), but the others little changed.

Bonds, however, are pretty clear with yields higher everywhere. Treasuries (+4.1bps) are back at 3.15% and the 2yr, at 3.48% is at its highest level since 2007. European sovereigns are also selling off with Gilts (+11.4bps) by far the worst performer as the combination of raging inflation and a lack of BOE backbone have investors fleeing fixed income. The latest is that Goldman Sachs, in an effort to outdo Citibank's call, have forecast CPI to reach 22.0% in the UK by the end of the year! Yet, the BOE remains woefully behind the curve. But the rest of Europe is under pressure as well with Bunds (+4.3bps), OATs (+3.4bps) and BTPs (+7.6bps) all selling off while the Bund – BTP spread widens further.

Oil prices (-3.3%) which got hammered yesterday after a surprise build in inventories, continue to fall due to fears of a deeper global recession. NatGas (-0.7% in US, +3.2% in Europe, +14.7% in UK) though has a life of its own. Russia once again shut down the NordStream 1 pipeline to Germany for more maintenance, ostensibly for 3 days, but fears remain that they will not reopen the pipeline thus adding further pressure to the situation. Gold (-0.7%) has not been behaving as a risk hedge of late as it suffers under the global interest rate rally, while copper (-1.1%) and aluminum (-1.4%) both reflect growing fears of a recession. In that vein, last night's Chinese Manufacturing PMI data printed at 49.4, slightly better than forecast, but still representing contraction.

And finally, the dollar is mostly stronger this morning, although not universally so. NOK (-1.2%) is the worst performer as oil's 8% decline in the past two sessions weighs heavily on the krone. CHF (-0.55%) is next worse, though, as it seems there is growing concern if the ECB gets aggressive, the SNB will have been left behind and the franc lose some of its luster. But the whole G10 space is softer this morning. As to the EMG bloc, KRW (+0.65%) was the beneficiary of the better than expected, albeit still weak, Chinese data, with CNY (+0.2%) the next best performer as the PBOC continues to fix the renminbi at stronger than market levels trying to slow its descent. On the downside, HUF (-1.1%) is the laggard after PPI data there (37.9% Y/Y) exploded to new highs demonstrating the central bank remains behind the curve. EEMEA currencies remain broadly weaker as well (PLN -0.65%, ZAR -0.6%) amid the dollar's strength.

On the data front, this morning brings ADP Employment (exp 300K) after ADP revamped the metric. In fact, I wonder how economists are estimating this completely new data point, but that's the call. We also see Chicago PMI (52.1). On the Fed front, we have Cleveland's Loretta Mester

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and Atlanta's Raphael Bostic to speak with new Dallas Fed president, Lorie Logan, being formally introduced this evening. Yesterday the Fed hawks kept at it with more tales of higher rates for longer and little concern over a recession as the result.

Thus far, the low we have seen in the euro is 0.9901. Will that be the low for good? Despite my arguments above, which were made to insure we continue to think about all the drivers, I remain bearish the single currency and bullish the dollar in general. I have bought into the idea that the Fed really does mean to squash inflation and that means that monetary policy in the US is going to be substantially tighter than elsewhere. Remember, too, that starting tomorrow, the Fed will be doubling the size of QT, another issue that will have a growing impact on overall market liquidity, and one that should push the dollar higher as well. I would still buy dollars on the dips.

Good luck and stay safe
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