SMBC Capital Markets, Inc.

fxPoetry

June 1, 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.

Foretellin'

The calendar page, today, turned
And QE has finally adjourned
Now, looking ahead
We're watching the Fed
To see if some lessons they've learned

Alas, in what may be foretellin'
We heard yesterday from Ms Yellen
It turns out her view
That prices were due
To drop wasn't very compellin'

The regime is changing today as the Federal Reserve is officially entering its QT phase in an effort to tighten monetary conditions further, thus reducing price pressures. As of today, the Fed is going to allow $30 billion of Treasuries and $17.5 billion of mortgage-backed securities (MBS) to mature without replacing them on the balance sheet each month. If things go well, meaning there are no major market or economic dislocations for the next several months, then come September, they will double the size of that balance sheet adjustment. At least that is the plan right now. As it happens, though, the first securities won't be running off until June 15th when $15 billion of Treasuries will be maturing.

Some of you may not recall the last time the Fed attempted to shrink its balance sheet in 2017-18, but in the end, it didn't work out that well. Then Fed Chair (and current Treasury Secretary) Yellen explained when the process began that it was insignificant and would "be like watching paint dry" as the $3.5 trillion of assets they purchased in the decade following the GFC would be allowed to simply fade away. And that was true for the first year, or so, as the economy seemed to be ticking along, and in fact after President Trump chose not to reappoint her, everybody hoped things would be fine. Of course, back then, the amount that was rolling off started at just $10 billion per month and eventually grew to a maximum of $50 billion per month. But it turns out that when a central bank floods markets with seemingly infinite liquidity and prompts a major asset bubble, it is not so easy to deflate that bubble without other consequences. By September 2018, Chairman Powell was feeling his oats and explained that interest rates were "…a long way from neutral at this point" and likely had much further to rise. The rest, as they say, was history.

Equity markets immediately started falling and the S&P had declined by 20% at Christmas when Powell made his (in)famous pivot, promising patience with further rate hikes and then actually cutting interest rates in January. Of course, this was proof positive of the Fed put, as they could not tolerate a declining stock market. Juxtapose that outcome with the current much more rapid pace of balance sheet shrinkage as well as the much more elevated levels of financial market valuations and the opportunity for a more dramatic market shock seems quite real. Of course, inflation is significantly higher now than it was in 2018 and it is the number one priority of the Biden administration. (Even Ms Yellen admitted yesterday she was wrong about inflation's temporary nature, explaining she didn't understand the impact that things like supply shortages would have on prices. But kudos for owning up to it, whether she should have known better or not.) And so, the $64 trillion question is, will the Fed maintain its current policy stance in the face of declining equity markets. Essentially, what is the current strike price of the Fed put? While nobody obviously knows, if I were to guess, I would say that if (when) the S&P 500 approaches 3200, the Fed will not be able to stand the pain. We shall see.

But, as we start a new month, let's take a look at market activity. Risk is under a bit of pressure, but equity market movement has not been that large so far. Overnight we saw the Nikkei (+0.65%) lead things higher, although Chinese shares (Hang Seng -0.55%, Shanghai -0.15%) were not as well received after the Caixin Manufacturing PMI fell unexpectedly to 48.1. European bourses are also mixed with the DAX (+0.15%) edging into the green while the CAC (-0.1%) and FTSE 100 (-0.4%) are both softer despite PMI data that met expectations and are essentially unchanged from last month. US futures have been edging higher most of the session with the DOW (+0.4%) leading the way while the other two key indices are barely in the green.

Bond markets, however, are universally, if not dramatically, weaker this morning with Treasuries (+2.5bps) leading the way and European sovereigns (Bunds +0.3bps, OATs +0.9bps, Gilts +1.2bps) all just a shade softer in price. There is much discussion regarding the 10-year German bund as it trades to 1.12%, a very important technical level. A number of analysts have claimed that a break higher through that level could open the way for as much as 100 basis points further in rising yields. That would be quite interesting with respect to what happens elsewhere in Europe as it would not happen in isolation.

On the commodity front, oil (+1.4%) is bouncing after yesterday's sell-off that was triggered by a story that OPEC+ may boot Russia from their group and reallocate those production quotas to other members. Of course, the most remarkable aspect of the current high oil prices is that virtually no OPEC member is even producing at their current quota, with production running some 2 million bpd below quota. Historically, virtually every member would be 'cheating' with prices this high, pumping as much as possible. Now, arguably, they are still pumping as much as possible, it's just they don't have the ability to pump anymore. Combine this with the Biden administration's effective war on fossil fuels and you have the makings of much higher prices going forward. Elsewhere in the commodity space, NatGas (+1.8%) is rebounding as well, although gold (-0.4%) is under continued pressure after yesterday's 1% decline. Copper (-0.7%) and aluminum (-1.3%) are also falling, potential harbingers of weaker economic activity going forward.

Finally, the dollar is broadly firmer this morning, with the yen (-0.6%) the weakest G10 currency and suddenly looking like it wants to make another move above 130. Of course, the correlation between 10-year Treasury yields and USDJPY has been running at 0.864 since March, so it should be no surprise that higher Treasury yields are accompanied by a weaker yen. The rest of the bloc is mostly softer, but the size of the decline is around -0.2%, nothing to get excited about. EMG currencies are also mostly softer led by TWD (-0.8%) which fell last night on concerns about growth as well as equity outflows. But we are seeing broad weakness with PLN (-0.4%), CNY (-0.25%) and MXN (-0.2%) showing the breadth of the decline. This is very much a dollar rally story.

On the data front, we see ISM manufacturing (exp 54.5) and Prices Paid (80.5) as well as JOLTS Job Openings (11.3M) and finally, at 2:00, the Fed's Beige Book. Yesterday showed Housing prices are still roaring higher, although the Chicago PMI data was also quite robust at 60.3. But the fifth, and final, monthly regional Fed activity index, Dallas, was very weak, falling to -7.3, another indicator of slowing activity around the nation. The ISM data should be interesting today.

From the Fed, we hear from Williams and Bullard, with the latter almost certainly going to call for 3.5% Fed funds by year end. It will be of much more interest to hear what NY Fed President Williams says, with the question of whether he will consider a pause in September or not.

By all accounts, the dollar is back to its old tricks, rising on the back of the more hawkish Fed rhetoric and the higher US yields. For now, that story remains the bedrock of the market, so if you're view is that US yields have peaked, then you should look for the dollar to decline. However, if we are going to retest 3.2% and perhaps higher, the dollar has further to run.

Good luck and stay safe
Adf

The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.