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Trouble's Afoot

Each day when we turn on the screen
The thing we consistently glean
Is trouble's afoot
As growth and output
Are sliding into the latrine

But central banks worldwide don't care
As they deal with their worst nightmare
Inflation keeps rising
Which ain't that surprising
With policy blunders laid bare

Another day, another disaster across markets as not only is good news bad, but so is bad news. Risk assets remain under severe pressure as despite increased signs of slowing growth around the world, there are limited signs of slowing inflation. If you were trying to concoct the worst possible world for risk assets, this would be it; slow growth and rising prices, better known as stagflation. This outcome is a direct result of the policies that have been in place for the past 13 years (post GFC) and unfortunately for all of us in the private sector, we will now be paying the price for more than a decade of unfettered monetary growth combined with government disincentives to enhance productivity (i.e., paying people not to work).

Consider that economic growth is the result of just two things, population growth and productivity growth. What we have observed over the past decade is a decline in both of these factors which by definition means that economic output is destined to grow more slowly. This is made clear in the statistics we see (Nonfarm Productivity at -4.1% in Q2 while the labor force continues to shrink back to levels last seen before women entered the workforce in large numbers.)

So, the growth story is pretty straightforward, declining productivity as a result of the financialization of the economy and the corresponding reduction in corporate investment leads to lower future outcomes, outcomes we are feeling right now. The problem is that the political response to this situation was to take the 'easy' way out and allow central banks to artificially prop

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up economic statistics by flooding the economy with liquidity. The sequence was purposeful as Benny the Beard explained in 2009, the portfolio balance channel was a fancy name for the Fed buying Treasuries from investors thus driving down yields and forcing investors to move out the risk curve to lower rated debt and equities. Hence, a decade-long boom in risk assets with nary a hiccup along the way. This manifested itself in bubbles in stocks, bonds, real estate, collectibles and cryptocurrencies.

But then Covid showed up and the government response was to close all production but maintain consumption by handing out cash. If ever there was a recipe for rising inflation, that was it. And suddenly (not really, but central banks would have you believe that is the case), there was a lot more demand for stuff than its supply. Naturally prices rose, sharply in many cases, and after much naysaying via the transitory concept, central banks have finally been forced to administer the medicine. Alas, there is no spoonful of sugar for this medicine. With the Fed in the lead, and now truly sounding as though they are serious, especially given that the data continues to show inflation is gaining momentum rather than losing it (just look at core services inflation running at 6.3% Y/Y, it's highest in 40 years) it is increasingly clear that they are not about to back off the rate hiking cycle anytime soon. As such, the dollar remains the only asset of choice that is unlikely to crash in the near term. But that means that every other currency is going to remain under pressure adding further problems to every other nation as they seek out dollar denominated items like commodities and electronics. We have not yet seen the worst of things, I fear.

For instance, UK Retail Sales were released this morning and made for dismal reading with the headline number falling -1.6% (vs. expectations of -0.5%) while the ex-auto number fell -5.4%! One cannot be surprised that the pound has plumbed new depths this morning, touching as low as 1.1351 earlier in the session before bouncing back a bit. And given the ongoing disaster that is currently the UK, with energy prices soaring, a massive government spending problem and businesses being forced to close because of those energy prices, it is hard to get too optimistic. CPI there is at 10.0% and forecast to double by the end of the year. I wouldn't want to hold pounds either.

The point is that while no market moves in a straight line, the trend remains very clear. US interest rates are going to continue to rise taking the dollar along for the ride. Risk assets in the US, and elsewhere, are destined to continue to decline as the only true safe haven is a USD money market account. This cycle will end at some point, its just not clear, right now, when that will be. For hedgers, it is hard to forecast a dollar top before sometime next year at the earliest.

With that cheery thought to lead us into the weekend, let's take a look at the markets. Equity markets around the world have been under pressure. The Nikkei (-1.1%) and Hang Seng (-0.9%) both fell but not as much as Shanghai (-2.3%) which is surprising given the Chinese data was actually mostly better than expected (IP +4.2% Y/Y, Retail Sales +5.4% Y/Y, Fixed Assets +5.8% Y/Y) although Property Investment (-7.4% Y/Y) is still a disaster there. Perhaps the Shanghai market is selling the news, although there didn't seem to be any buying the rumor over the past week. In Europe, things are bad as well (DAX -1.3%, CAC -1.1%) except for the UK (FTSE 100 +0.2%), which does seem like a buy the fact (the rumor was clearly sold there). And, after yesterday's equity weakness in the US, futures are down a further -0.2% across the board at 7:00am.

Bonds continue to sell off as well with Treasury yields higher (+1.8bps) and the same true in Europe (Bunds +1.9bps, OATs +2.2bps, BTPs +2.5bps, Gilts 0.0%) with the UK the exception

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here as well. The US curve has inverted further as 2yr yields are pushing toward 4.0% and Fed funds futures are now pricing a terminal rate of 4.5% come March with less belief in an eventual downturn in rates. There have been several analyses by investment banks and well-known investment managers that the terminal rate will need to rise above 5.0% in order to truly squash inflation. If that is the case, be prepared for further stock market declines.

Commodities, meanwhile, have gotten the recession message as although oil (+0.8%) is higher today, it got crushed yesterday, falling nearly 4%. NatGas (-2.6%), too, has been a yo-yo of late, falling sharply yesterday as well after having exploded higher on Wednesday. On the metals front, gold (+0.1%) is trying to stabilize after a sharp sell-off yesterday while copper (-0.7%) is offered as well. The exception here is aluminum (+1.8%) as the continued reduction in supply due to the massive rise in energy prices, is impacting the price significantly. (As an aside, aluminum is sometimes called solid electricity as the cost of fabricating it from bauxite ore is almost entirely due to the electrical power required to make it.)

Finally, the dollar continues to rise pretty much across the board. In the G10 today, NOK (-0.65%) and GBP (-0.6%) are the worst performers but CAD (-0.35%) is also feeling the pinch of softer oil and metals as well as the Fed effect. But really, the only gainer today is JPY (+0.2%) as continued concerns over potential BOJ intervention have prevented the yen from falling further. Speaking of intervention, KRW (+0.4%) was one of two EMG currencies to rally after the BOK was seen sniffing around the market as the won approached 1400, apparently the first line in the sand there. As well, HUF (+1.0%) is higher on the back of news it will be draining liquidity from the market. but otherwise, it is a sea of red led by THB (-0.75%), ZAR (-0.6%) and TWD (-0.55%). CNY (-0.2%) is now firmly above 7.00 and there has been no obvious concern by the PBOC so look for this market to test the 2019 highs of 7.1850. In the end, I see nothing to stop the dollar's move higher.

On the data front, today brings Michigan Sentiment (60.0) which is off its absolute lows, but still lower than any cycle previously. And there is no Fedspeak as we await the meeting next Wednesday. As it is Friday and option and futures expiration, there certainly can be some fireworks in the equity markets. But as to the dollar, the trend remains your friend.

Good luck, good weekend and stay safe
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