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am FX

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THE TIMES

Tuesday September 16 2008

Lehman collapse sends shockwave round world

Shares and oil prices plunge, thousands lose jobs

'We are now unquestionably in the worst financial crisis since the Great Depression'

On this day in 2008

Current Views

Flat, expect hawkish FOMC and higher USD next week. More chop 'til then

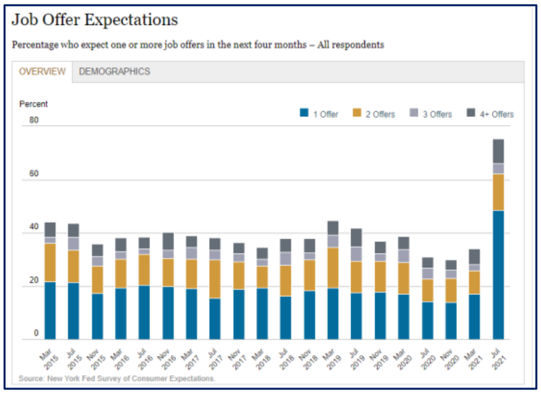
One week

Next week's FOMC meeting is setting up a bit like the June meeting. Then, the market leaned into a complacent dovish view and the dots took things hard the other way. My view is that the risk next week is hawkish.

Yesterday's CPI does not change my view. The error bars on the economic data are wide enough these days that yesterday's CPI miss does not change anything. In June, the market failed to see that the dovish core was losing its hold on the rest of the committee, and I think that is true into this meeting, too. Here's why:

- The 12-month average of Core PCE is above 2.0%. This satisfies the one-year memory idea that was initially put forth by Bernanke and subsequently [discussed by Clarida]().

- NFP weakness is a labor supply, not demand story. Sure, Powell ignored this fact at Jackson Hole, but the committee knows better. JOLTS don't lie. The labor market is tight. See chart at right, courtesy of Tanguy Bretagne. Job offers are coming in fast and furious.

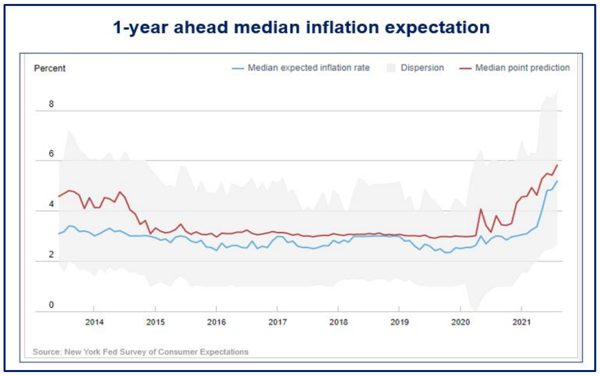


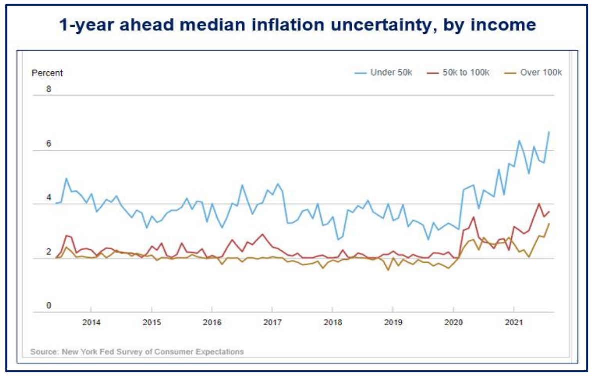
  As school returns, and low wage workers move around to find jobs now that benefits have expired, labor market imbalances will start to heal. The return of in-person school in the US helps. The end of benefits will help. Time for employees to move out of abandoned city areas to new jobs in the booming suburbs will help. Some of this will be soon (September, October data should finally start looking better as labor supply returns) and some will be gradual. Phil V. said this yesterday:

  > *Just talked to a friend who is a large institutional investor in US equities. The impression they have about US jobs situation is that people are in the wrong place. Low-skilled workers are languishing jobless in cities with over-capacity relative to demand. Meanwhile, out of town demand has rocketed and job openings are off the charts. But the workers just don't live there.*
  >
  > *Either people go back to cities post COVID, or the workers gradually move out to the jobs out of town, or more likely a bit of both.*

  I would bet on both. With the end of benefits, I would bet on this stuff starting to play out pretty soon. I am bullish the next three NFP prints as economists will mark down forecasts to anchor on prior low figures just as the supply shock eases.

- New York Fed inflation expectations are aggressively higher. The two charts on the next page give you a sense of it. The first one (on the left) is notable because the BOTTOM of the dispersion now sits **above** 2% for the first time. Consumer surveys have a notoriously bad inflation forecasting record, but very large moves in grassroots inflation sentiment also threaten to activate the expectations channel and the Fed knows this. [Here is a nice, short, related article]().





Inspired by Tanguy Bretagne's most excellent commentary

The second chart (on the right) is particularly relevant. Lower-income families are saddled with most of the inflation uncertainty due to their higher marginal propensity to spend, and lesser ability to absorb financial shocks. Worth mentioning that the NY Fed survey is not in the Fed's common index but UMich is (and that's out this Friday).

There is no trade here yet. The Fed meeting is next Wednesday, and no short USD positioning has built up in anticipation of the meeting. But that's my lean. One final thing: FOMC meetings during the withdrawal of stimulus can feel surprisingly hawkish because we have become so accustomed to what feels like continual dovish Fed messaging.

A scenario to keep on your radar

Remember in Q3 2014 when FX vol was at all-time lows and then KABOOM—The USD ripped higher? The current setup feels a bit like that. In September 2014, USDJPY vol was trading below 5% (just like it is now). Then, in Q4 2014, USDJPY rallied from 105 to 118. A big chunk of the 2014 USDJPY move was driven by the BOJ, but Fed expectations were a meaningful driver. While we are not as deep into the normalization cycle as we were in Q4 2014, history rhymes more than it repeats.

Still, there are similarities, and the current USDJPY setup looks a lot like a tiny red bull flag inside a giant green bull flag formed by the Abenomics rally in 2012/2014. See chart at right.

I'm not calling for a monster 2014-style USD rally at this juncture. I do, however, think you should at least have "surprising, impulsive USD rally" on your Q4 2021 bingo card. The entry point is nice down here, CADJPY is crazy low compared to oil, and December 110.00 USDJPY calls are cheap.

Closing thought (USD/CNH)

What the heck is USD/CNH doing down here?

Imagine a major industrial economy pivoting away from free markets and toward more state control as their economy slows and their 2nd-largest property developer slides towards oblivion. Imagine people openly asking … after a 20-year love affair with that country as an investment destination… whether it is even investable anymore. To invest there, one must guess (and avoid) arbitrary crackdown targets.

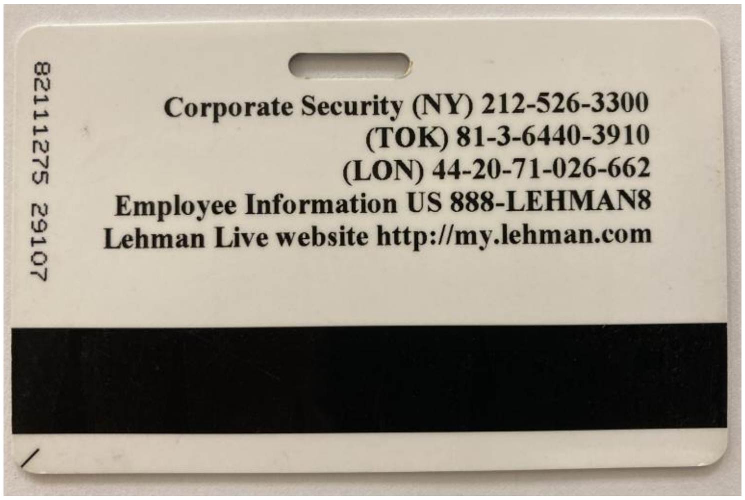
Would you expect capital to be flowing IN or OUT of that country? CNH strength is impressive, but it doesn't make much sense. The China narrative has turned, and the price should follow at some point. *The market is not always right!* Buy 3-month or 6-month 6.50 calls in USD/CNH.

good luck ⇅ be nimble

I find it interesting that most people who worked at Lehman Brothers are still proud they worked there (I am). The same cannot be said about employees from most other bankrupt firms!

Ex-Enron or WorldCom or WaMu workers don't seem to have the same post-Chapter-11 swagger.

https://en.wikipedia.org/wiki/Bankruptcy_in_the_United_States#Largest_bankruptcies



If life hands you Lehmans, call LEHMAN8

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