Tuesday, December 07, 2021

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FX

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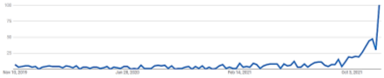


Google Search activity for “Web3” over the past two years

Current Views

Short ETHUSD @ 4210
Stop loss 4902 / Take profit 3010
(From MacroTactical Crypto #4)

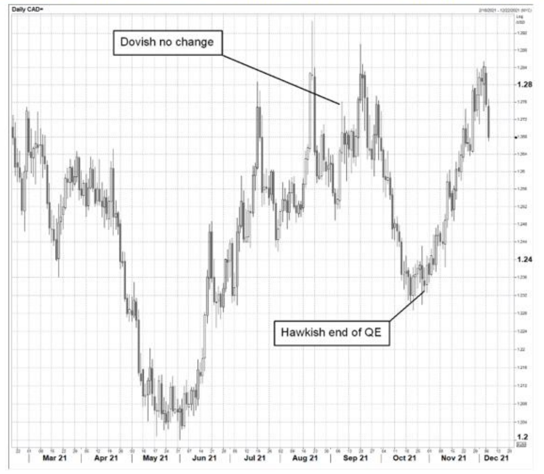
BoC and Fed

Bank of Canada

BoC tomorrow could be interesting from an economics and policy point of view, but the outcome will have a short half-life in currency markets as the primary driver of high-beta FX like CAD has been risk appetite, not monetary policy. The basic set up:

- **Tiny hikes are priced in for tomorrow** (20% chance). This seems like free money to fade[1]. More than a full hike is priced by March 2022 and more than 5 hikes total for 2022. This includes some premium for a small chance of a 50bps hike in there.
- **I don’t see a USDCAD trade here**, other than smash and grab on the outcome. A hawkish BoC makes sense after the stonking jobs data, but with so much priced in and no MPR this meeting, I could see a mild disappointment. I don’t see any value in going into the meeting short USDCAD. For the cyclical currencies, SPX and crude oil performance are more important than monetary policy these days. Anyone who recently went long NOK or NZD on hawkish central bank expectations has found this out the expensive way.

Last two Bank of Canada meetings were smash and grab events



- **The hawkish October 27 Bank of Canada meeting was the LOW in USDCAD**. See chart.
- **Canadian CPI and jobs market en fuego.** Employment before COVID was 19.13 million and now Canada employs 19.36 million people. The Great Resignation and worker shortage story that has bedeviled the USA is not as evident in Canada. On the face of it, this job growth is hawkish but on the other hand you could argue that with more workers available, supply pressures in the Canadian labor market are less dramatic (i.e., counterintuitively dovish?) Canadian hourly earnings are growing at 3% and US earnings are growing at 5%.
- **The Fed pivot makes it easier for the BoC to amp up the hawkish tone** and set the stage for a January or March hike.
- **There are a few offsets to the raging employment and inflation** situations. Home prices in Canada were flat last month, for example. While monthly data is super volatile, that may give the BoC some hope on housing inflation.
- **The output gap is always a wildcard**. A few weeks ago, Schembri said “The evidence for Canada indicates that the relationship between labor market conditions and inflationary pressure has weakened and become difficult to measure — especially in periods of excess demand.” Since that comment, the UR has dropped from 6.6% to 6.0% and earnings moved from 2.1% to 3.0%. It will be difficult for the BoC to argue later closure of the output gap than their prior estimate of “middle quarters of 2022”. They could certainly argue *earlier* closure though.

Federal Reserve

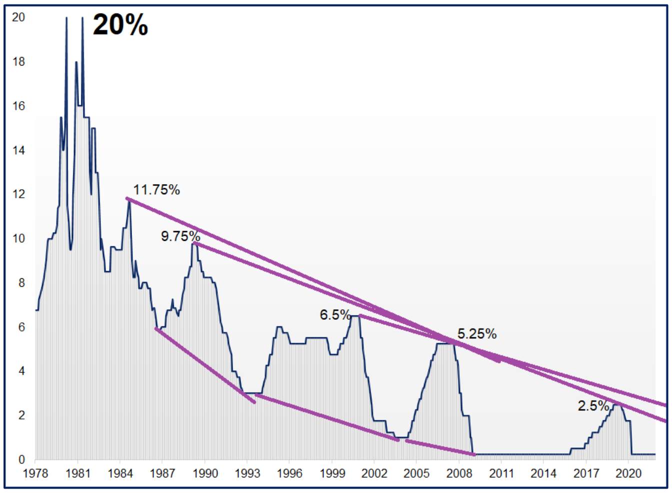
Three big questions about this Fed cycle:

[1] No such thing as free money

1. **Can the Fed hike rates more than they did last cycle?** Since 1980, the answer to this question has always been no. Every Fed tightening cycle has peaked lower than the last. It is extremely important to see whether the Fed can take us through the prior cycle high this time (2.5%), or not. One would think that 6% inflation and the hottest labor market in our lifetime would be enough to get us to price more than last cycle. But the market is not entertaining much of a US rate hike cycle at all so far. The December dots will be interesting.

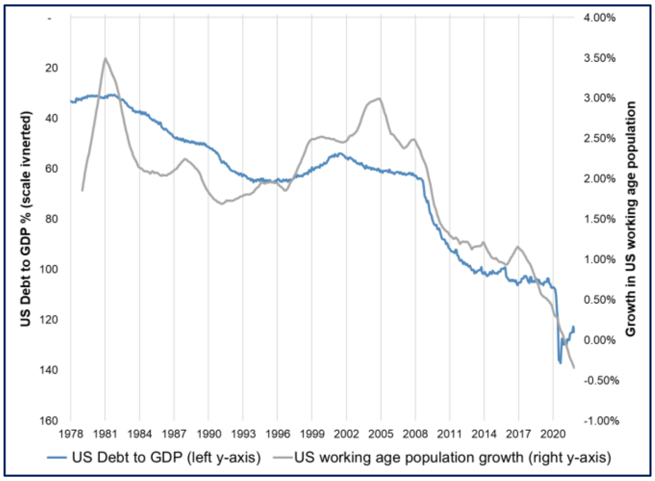
   Here is the chart of the lower highs in Fed Funds since 1978[2].

   Chart1: **US Fed Funds,** 1978 to now



   Most economists attribute the steady decline in rates to debt and demographics. For example, this kind of stuff:

   Chart2: **Working age population growth and US debt/GDP,** 1978 to now



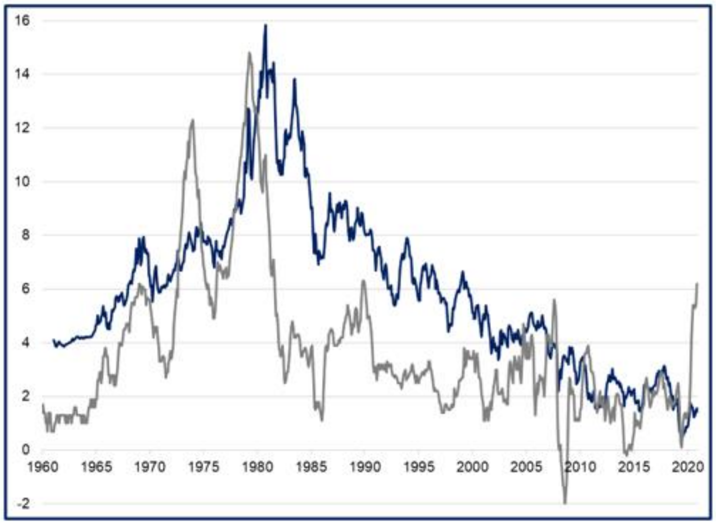
2. **What might get 10-year rates up off the floor?** 6% price rises? Nope. 5% wage increases? Nope. Not record-shattering, MMT-style fiscal spending. Not inflation as the number one topic at the dinner table. Not the partial disintegration of public belief in fiat currencies... Then what?? US 10-year rates are the beachball that remains stubbornly underwater.

   It is tempting to take the signal from the bond market and from the inversion of Z3 vs. Z5 to mean that rates can just simply never go higher. The reasons rates can never go higher are simple:

[2] Interestingly, this is also a solid graphical representation of "how much fun Brent Donnelly has at amusement parks", going back to 1978.

Demographics and debt. As shown in today's Chart2 and well explained by smart people like Dave Rosenberg and Lacy Hunt. These two deflationary D's are not going anywhere—they are getting worse. So that is probably a fairly good explanation as to why the market is assuming this cycle will continue the trend of lower and lower peaks and fewer rate hikes.

Chart3: **US 10-year yield vs.** US YoY CPI



BUT! Is it possible rates are lagging? I think this is worth keeping in the back of your mind. Inflation topped in March 1980, but US 10-year yields did not peak until 18 months later in October 1981. See chart at right.

Is it possible that there is some mechanism that makes rates slow to react to inflation? It would make sense that we simply don't believe the change in inflation will be persistent after living through so many years of high inflation (1980s) or low inflation (now).

Maybe markets just lack imagination and another six months of six percent inflation will shake bonds loose from their torpor? Not the base case, but worth keeping in the back of your mind. I bet there were some super-annoyed bond market longs in September 1981 as CPI was coming in much lower and yields made new all-time highs. Then: boom. Biggest bull market in history, pretty much.

To be 100% clear here: My base case is the Rosenberg and Hunt conclusion (deflationary dynamics eventually return) because we have had so much inflation and so little bond market reaction. I would rather be long bonds, not short. But it's a good time to keep an open mind.

3. **How hawkish will the Fed be at the December 15 meeting?** The range of outcomes looks pretty wide to me. I keep getting asked "don't you think the pivot is priced in by now?" My answer would be: not necessarily. The day we see 35bps priced into an upcoming FOMC meeting (more than one 25bps hike), maybe that's the point a hawkish pivot is priced in. The Fed are so late in normalizing that maybe they just want to go hard at this point and get to neutral so they don't jam the US public with another year of 6% inflation. By discarding "transitory", Powell has upped the range of what could conceivably happen at the next Fed meeting. Yes, a lot is priced in. And yes, a lot more could get priced in.

   The Fed has told us they no longer believe the word "transitory" is appropriate and they have told us that inflation risks are to the topside. Meanwhile, they are still buying MBS and rates are at the all-time lows. If they have really, truly pivoted, the December meeting could easily be super hawkish via high dots, hawkish messaging, and a presser that opens up unlimited optionality which could imply 50bp hikes or hiking at faster than a quarterly pace. This would probably only matter for the front end, though, and the rest of the curve will keep flattening and / or inverting. My guess is the market wants to buy USD into the event.

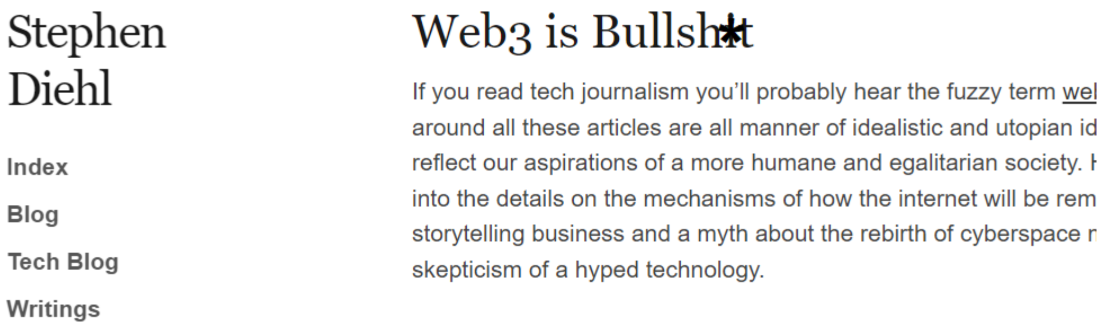
Have a bullsh*t free day.

good luck ⇅ be nimble

As a crypto agnostic, I like to read varied views on the industry and on the technology. Stephen Diehl and Travis Kimmel are two technology experts who produce useful skeptical commentary on blockchain. As opposed to philosophical permabear skeptics, who I find less interseting (Taleb, etc.), the technology skeptics have more to contribute to the debate. If Web3 ends up more like VR (disappointing) than Web1 (super awesome), that obviously matters.

Stephen Diehl's latest skeptical take is fantastic writing (and has a great, clickbaity headline). He's probably a bit in the permabear/confirmation bias bucket, but still a fun and useful read. There are so many bullish maximalists, it's useful to read some skeptical takes in an attempt to avoid getting absorbed by the Borg-like Web3 hype machine.

https://www.stephendiehl.com/blog/web3-bullshit.html



Web3 is Bullsh✱t

If you read tech journalism you'll probably hear the fuzzy term wel
around all these articles are all manner of idealistic and utopian id
reflect our aspirations of a more humane and egalitarian society. I
into the details on the mechanisms of how the internet will be rem
storytelling business and a myth about the rebirth of cyberspace r
skepticism of a hyped technology.

And here's a good read on GameFi:
https://www.mechanism.capital/crypto-gaming-thesis/

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