SPECTRA MARKETS

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am
FX

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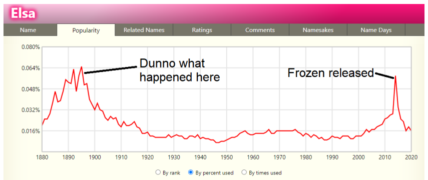


The popularity of the name "Elsa" since 1880 looks like an altcoin chart

Current Views

2/2/22: move all stop losses to entry point

Short USDJPY @ 115.31
Original stop loss was 116.11
Take profit 113.92

Short USDCHF @ 0.9300
Original stop loss was 0.9381
Take profit 0.9111

Long AUDUSD 0.7041
Original stop loss was 0.6984
Take profit 0.7219

Long 03FEB CADJPY
90.00 put
Spot ref: 90.80 /// Price 75 pips
Take profit 88.65

Interesting Signal

A signal I find particularly useful is when a strategist or economist I respect, who has had an accurate view for a while, decides to change their mind. The reason I find this powerful is that economists and strategists have very high switching costs and most humans exhibit confirmation bias. If a high-profile person has been correct on a market or economic narrative for a while, their default choice is going to be to sit on it and keep pounding the table. If they change their mind, a high bar has been cleared and the new information is compelling enough to that person to trigger a change of view. That's useful.

Peter Boockvar's inflation views have been timely and accurate in this cycle. I remember last summer, when I was on Team Transitory, I thought he was kind of nuts saying that inflation would stay persistent when clearly prices of lumber and used cars etc. had all started to come back down. Oops. He was right![1] Peter stuck with his high and rising inflation view until a few days ago and then yesterday he wrote:

> I want to reiterate my belief that the peak in the rate of change in inflation will come in either February or March and that the intense pressures seen will begin to ease. If correct, the only question then is how soon and quick does it decline. I'll continue to argue that inflation will remain sticky and that a 3-4% range will be the first settling point and we are not going back to 1-2% anytime soon.

I asked him why and he responded:

> Beginning in March, the year-over-year rate of change for CPI begins to get tougher and much more so in April and May as these are the 2021 comparisons: 2.6%, 4.2% and 5% respectively. So just from that standpoint the headline figures will start to slow y/o/y. I do believe that post-Christmas holiday and the supply rush ahead of the Chinese New Year will likely mark the peak in supply chain strains, however this will still take time to relieve itself.
>
> On the demand side, consumers who have spent aggressively for goods over the past two years will start to moderate their purchases both because savings rates are dropping, and fiscal checks are not to be repeated but also because of sticker shock. This said, what will keep inflation still sticky is 1) rising labor costs which is the biggest expense line, 2) rising rents will still show up in an accelerating fashion in both CPI and PCE this year, and 3) companies will still spend the next year or two trying to recapture their lost profit margins via price hikes even if their cost inputs start to recede.

I thought that was interesting and logical so I'm sharing it with you with Peter's permission. His website is https://boockreport.com/ and he publishes tons of great stuff, including timely updates right after economic data releases. This is not a paid endorsement; I just like his stuff.

Here's a related story from Reuters: Good news on supply chains from Germany. Excerpt:

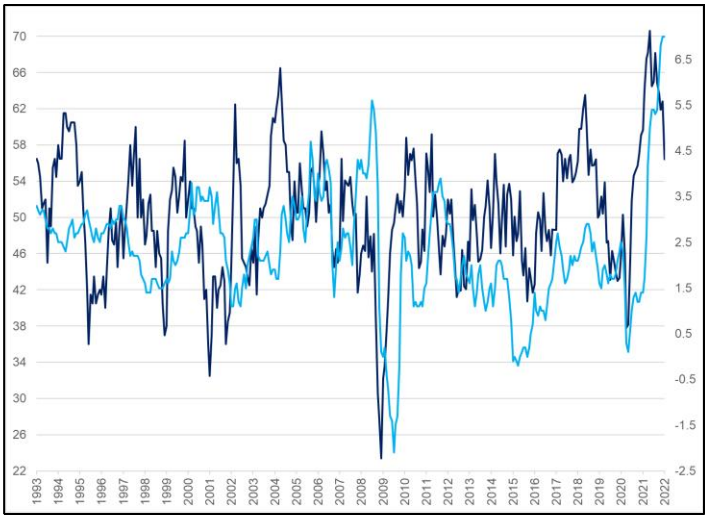
> ***German retailers report fewer supply bottlenecks in January (IFO).***
>
> BERLIN (Reuters) - The delivery bottlenecks that have been plaguing German retailers eased significantly in January, an Ifo institute survey showed, with 57.1% of shops saying they had failed to deliver all goods ordered, down from 81.6% in December.

[1] For sale: Team Transitory jersey, barely worn

Booming US inventory numbers and rapidly falling shipping rates corroborate a gradually improving supply story as Peter suggests in the quote above. Also, in the ISM data (released yesterday), there is a lesser-known sub-index called Backlog of Orders and it came off aggressively this month. Remember CPI is a lagging economic indicator.

Here is the Backlog of Orders vs. US CPI. The backlog figure on its own means nothing—it peaked in mid-2021—but the size of this month's drop is another in a long string of numbers that show the US economy of January 2022 is nothing like the economy of 2021.

ISM Manufacturing Backlog of Orders vs. US CPI YoY



Note that the backlog number is volatile but all the big moves in CPI are preceded by a big move in backlogs beforehand.

ISM Backlog Details

Backlog of Orders	% Reporting	% Higher	% Same	% Lower	Net	Index
Jan 2022	93	24.7	63.5	11.8	+12.9	56.4
Dec 2021	90	38.0	49.7	12.3	+25.7	62.8
Nov 2021	92	35.2	53.3	11.5	+23.7	61.9
Oct 2021	91	36.4	54.4	9.2	+27.2	63.6

https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/january/

To me, there is now a preponderance of evidence that things are cooling modestly in the US. Could be temporary omicron stuff or could be more nefarious fiscal cliff. Either way, for me an interesting question that comes out of today's am/FX is… If CPI drops back to the 3%/4% area in Q2/Q3… What does that mean for markets? 3% CPI is still high, and the jobs market is still mega hot. I'll let you think about that one for a bit. Answers welcome.

Central banks follow the market

It's worth remembering that during tightening cycles, central banks mostly follow market pricing, not the other way around. Dudley acknowledged this explicitly yesterday in his Bloomberg editorial. Here is the key excerpt:

> ***What are the prospects for a 50-basis-point increase in the federal funds rate at the March meeting?***
>
> The likelihood is minimal for several reasons. First, it would surprise market participants. Federal funds futures prices now imply about a 20% probability of such a move. This is important because Powell strongly believes that surprising markets is not a good way to conduct monetary policy. Surprises create confusion about how the Fed will respond in the future as the economic outlook changes. That uncertainty, in turn, loosens the linkage between monetary policy and its impact on financial market conditions, which determine how monetary policy affects economic activity.

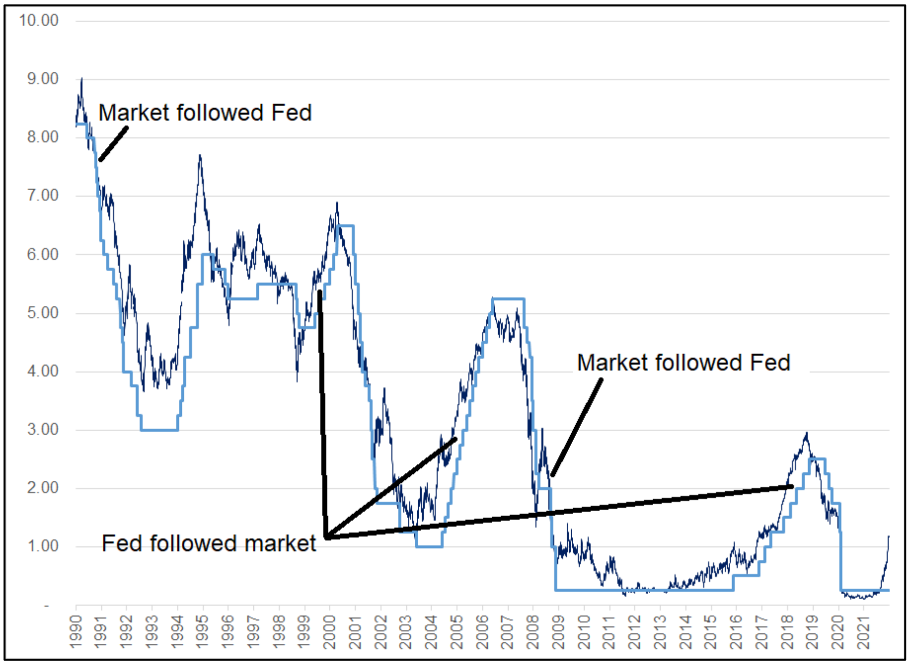
If you don't want to surprise, you do whatever is priced in. That's a strategy that explicitly follows whatever the market is telling central banks to do. You can see in the next chart that generally the market leads almost all the cycles, but the hiking cycles are more clearly led by the market, while the cuts in the 1990s recession and the second leg of easing in both 2001 and 2008 were started by the Fed, not the market. You can see in both those cycles the market started to price the end of easing and then the Fed hammered it again. The only hiking cycle where the market did not lead the Fed was the 1993/1994 cycle where the data was so strong that the Fed and the market both reacted at once.

There is mad circularity in this process because of course the Fed telegraphs what they are going to do, and markets react to that. So, it is not fair to say the Fed is just a slave to the market. Still, when they are tightening, they would much prefer to do what is priced in so that they can tighten financial conditions in a deliberate and controlled manner and not blow the doors off risky assets.

The Fed following the market in tightening cycles is one reason it's hard to play the "too much is priced in" game. It's circular. The more that is priced in, the more the Fed can hike.

US 2-year yield vs. Fed Funds

The Fed mostly follows market pricing especially during hiking cycles



This is worth remembering as we go into tomorrow's ECB meeting. Sure, they said they don't expect to hike in 2022 but as the market prices it in, it gets easier for Lagarde to say "Meh, allons-y." Absurdly low real rates and all that.

Tactics

I have moved all my stop losses to the entry points on the short USD trades from Monday's note: "am/FX: A nice setup for short USD". I think we are consolidating here as AUD and GBP are particularly overbought micro term but fine overall. Moving the stop loss to the entry point is generally amateur behavior because the market does not care about your entry point—but when I looked at the logical stop for each trade, they were very close to my entries anyway. This approach is less complicated than providing a paragraph on each currency to explain why I put my stop in each place. There is always a tension in my writing between explaining stuff adequately and being the boring pedantic details guy.

Finally: Do you want to build a snowman?

good luck ⇅ be nimble

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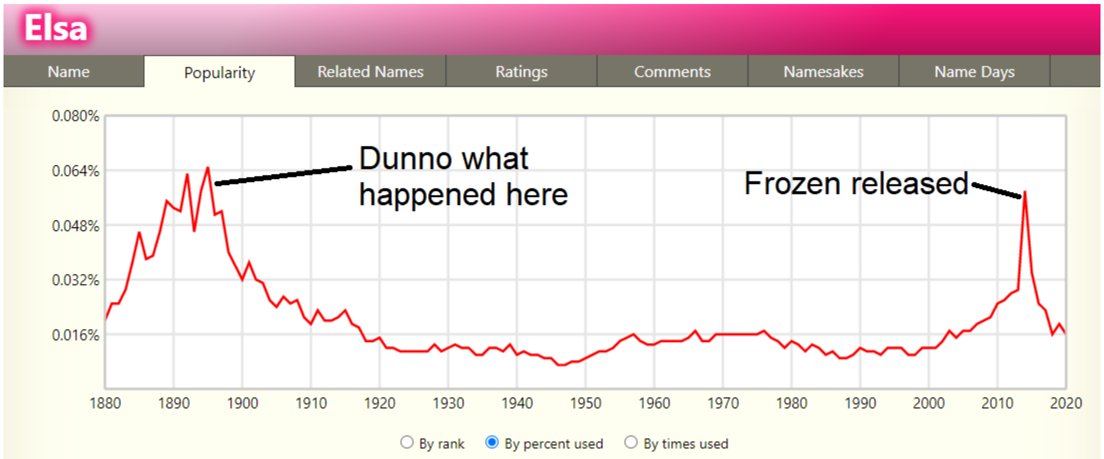
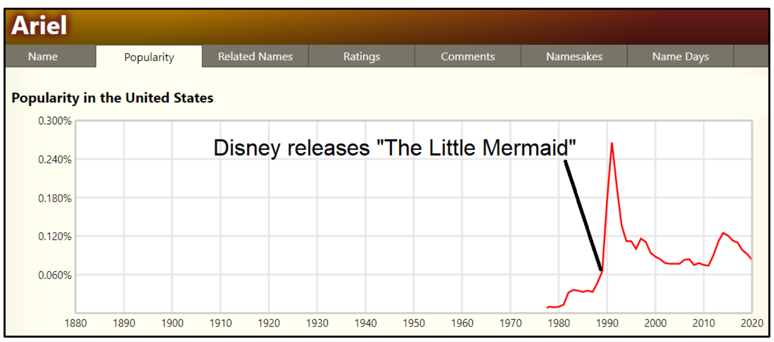
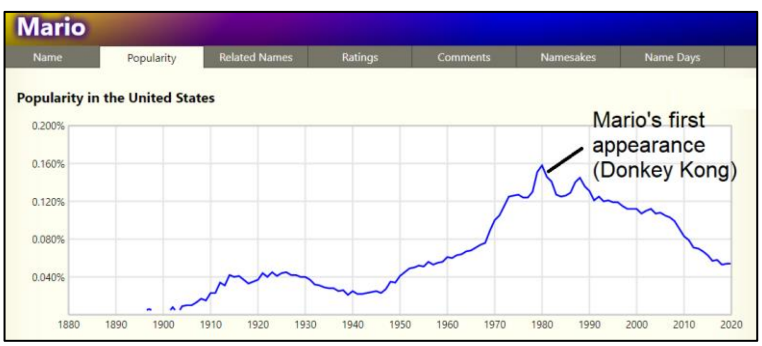


Actually, I do know what happened in 1890 thanks to a Zachary Kimball on Twitter!
https://en.wikipedia.org/wiki/Swedish_emigration_to_the_United_States





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