Tuesday, July 19, 2022

am/FX

Brent Donnelly

bdonnelly@spectramarkets.com
(212) 398-6230

Correction: In yesterday's am/FX, the non sequitur was accompanied by an image of an asymmetric cake that, when cut, would not yield equal pieces. High sprinkle density on the bottom vs. icing puff frequency on top yields a completely different cake-eating experience, especially for children.

We regret this error and are taking all steps necessary to enhance our processes and controls to ensure this does not happen again, as serving our valued customers remains our highest priority.

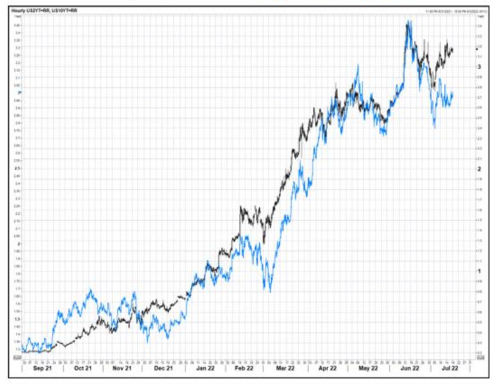
Current Views

Flat

anticipation

Rates are not backing off much. With the moves in commodities and the talk of recession everywhere, you might think that US 10-year yields would at least be at a 3-month low or something. They're not. See chart.

US 2-year yields and US 10-year yields



The current cocktail of high inflation, strong jobs, meaty chunk rate hikes, housing coming off hard from stratospheric levels, and so on is a huge crazy mélange of high levels, slowing rate of change, and contradictory information. Sure, some of it is a matter of leads and lags, but we really have no idea whether core inflation is about to drift back to 5% and bottom out there, or whether it's about to crash back to 2%. And for all the anxiety about yield curve inversion, the big daddy of the curve indicators (US 3-month vs. US 10-year yield) is still +49.

Maybe this out-of-consensus scenario is worth keeping in mind:

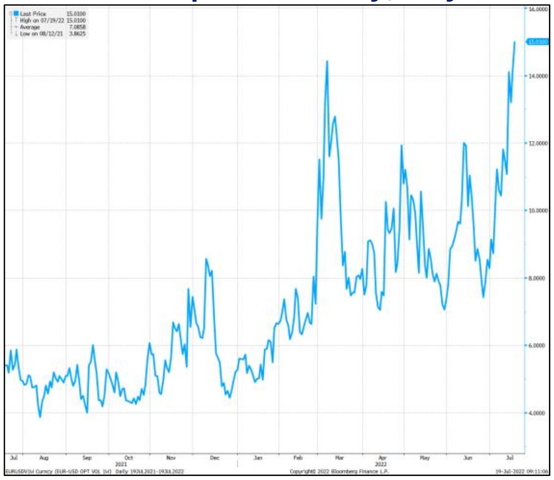
- US housing soft landing like Canada in 2013 and 2018
- Soft data overstating economic weakness due to the way consumers feel real vs. nominal pain
- US jobs market softens but remains tight
- Inflation sticky

Not really a view here; I'm just thinking about various hypotheses as rates look sticky even as prognosticator consensus has pivoted from "all humans must be short bonds" to "yields look yummy and we're already in recession." I am abstaining from FX views for now as the corrective move lower in the dollar seems reasonable but not worth chasing with the 21JUL ECB meeting and Nordstream decisions looming like a UK heatwave.

anticipation

Markets are on edge ahead of ECB and Nordstream.

EURUSD 1-week implied volatility, July 2021 to now



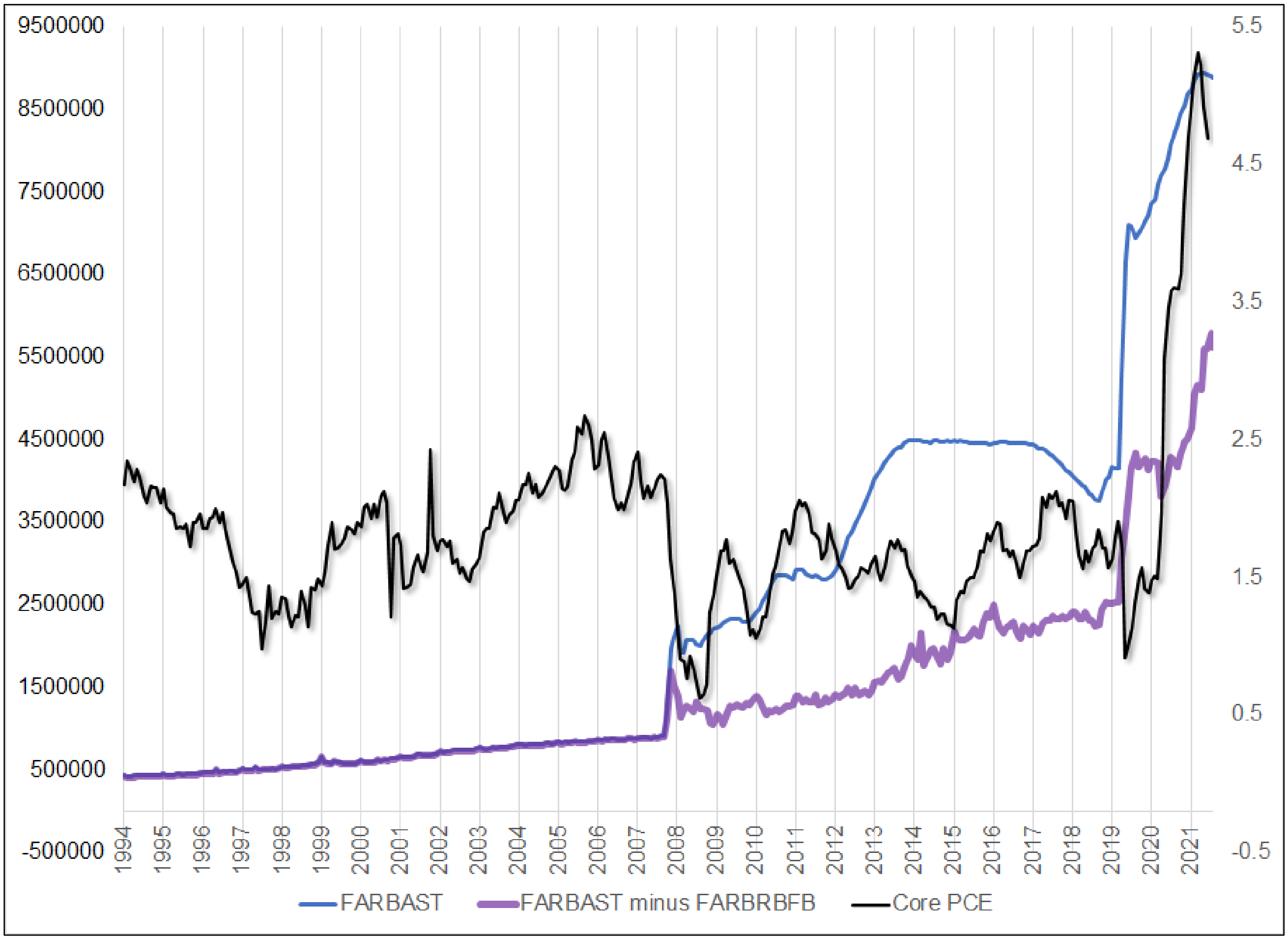
I know not everyone likes the CFR, but whatever

An interesting piece here from the Council on Foreign Relations. It is an attempt to explain why QE did not create inflation in the period from 2008 to 2020 but created massive inflation in 2021. I had trouble perfectly replicating the charts in the blog post, but here's my best effort:

The main point is that QE only causes inflation when Fed balance sheet expansion diverges from bank excess reserves. That is, looking at my chart below: the blue line (Fed Balance sheet) was mistakenly thought to be a catalyst for inflation in 2008 as many economists and critics wrongly forecast raging inflation, but it's actually the purple line (Fed Balance sheet minus Excess Reserves) that triggers it.

This makes sense, I think. When the Fed buys bonds from banks, and that money sits in bank reserves, there is no transmission to inflation. When the money is lent into the real economy, there is transmission.

Fed B/S, Fed B/S minus Bank Assets, and US Core PCE YoY

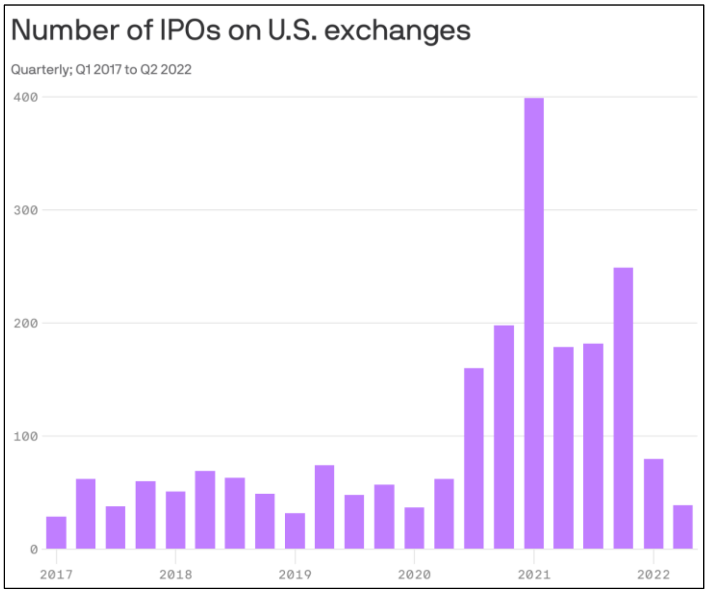


The piece is a bit overconfident on a conclusion drawn from a single input, and one of the authors has a debatable track record. Another grain of salt is that the blog claims they predicted this inflationary burst, but if you read the post they link to, their prediction was simply that inflation would return to 2% (not that inflation would rip to heights last seen when Cyndi Lauper was a fresh face on the pop music scene). Also, it's obvious that fiscal policy played a role in stimulating both inflation and bank lending in 2020 and 2021 so that could be the missing variable here.

Anyway, I thought it was an interesting hypothesis and a nice simple way of using data to explain why QE1, 2, and 3 didn't trigger inflation, but QE4 did.

Boom / bust USA, exhibit #723

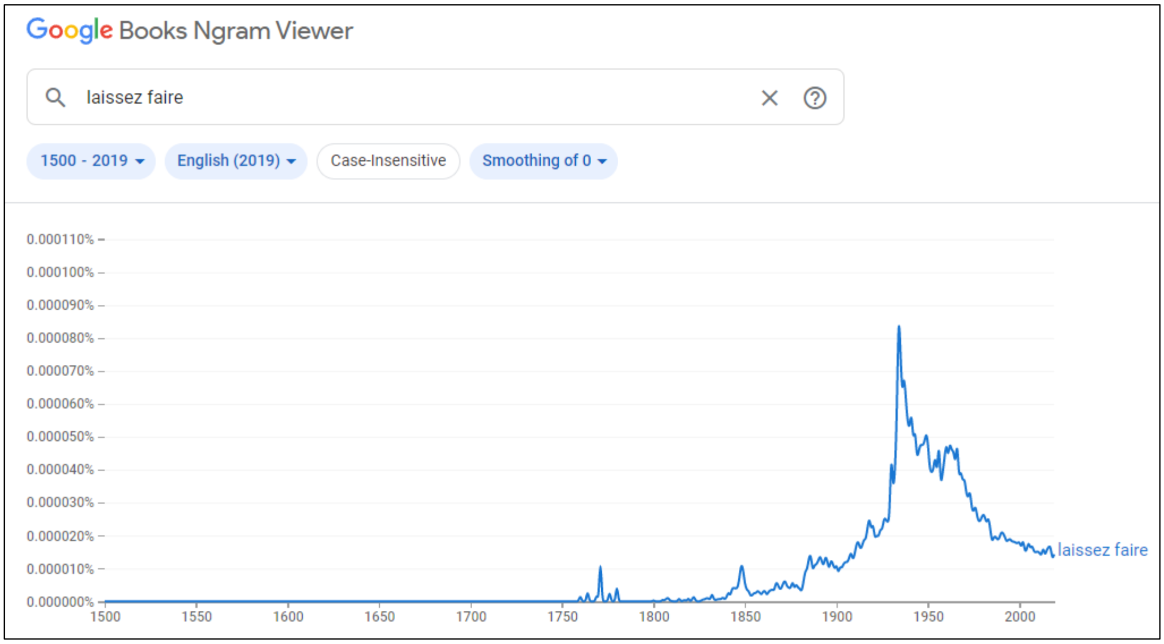
From Axios:



Final Thought

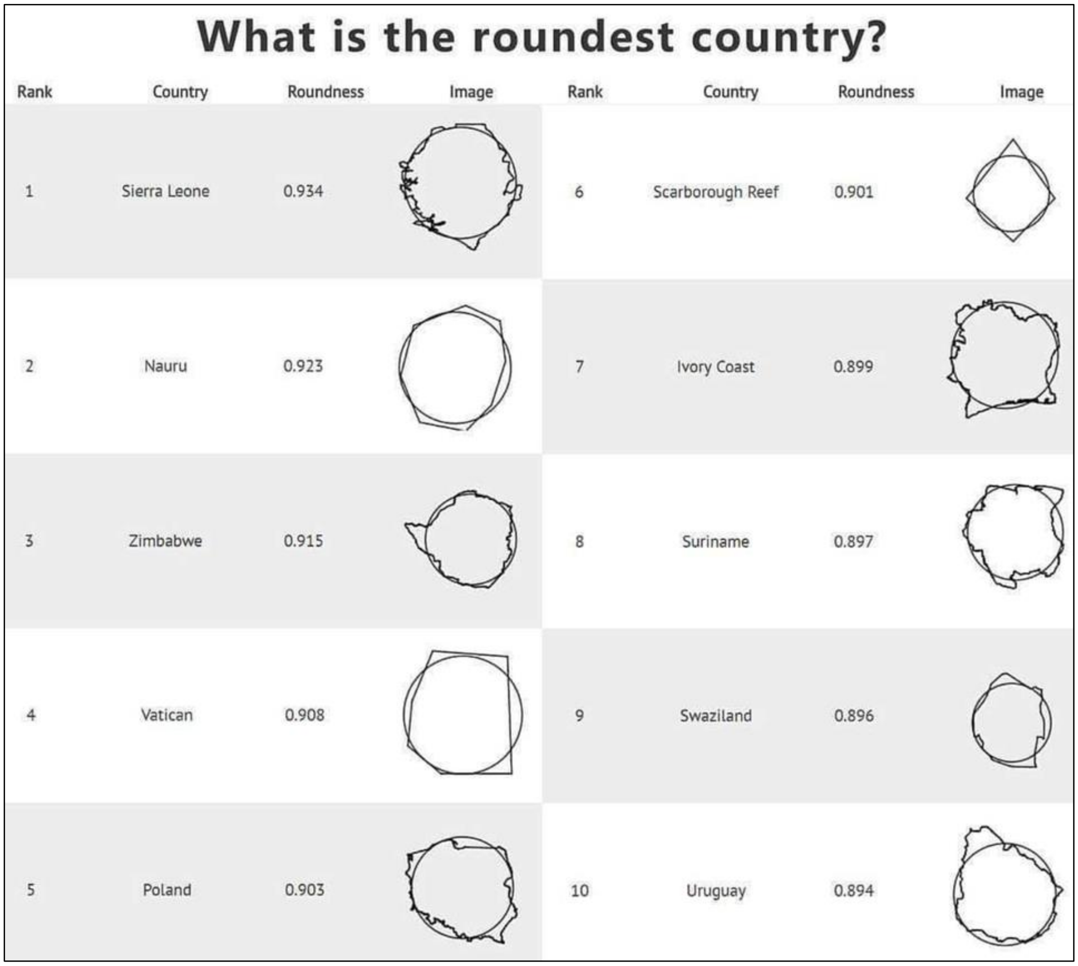
Is it too early to buy the dip on a free markets renaissance?

Frequency of the term "laissez-faire" in books published from 1500 to 2019



Have a circular day.

good luck ⇅ be nimble



What is the roundest country?

Rank	Country	Roundness	Image	Rank	Country	Roundness	Image
1	Sierra Leone	0.934		6	Scarborough Reef	0.901	
2	Nauru	0.923		7	Ivory Coast	0.899	
3	Zimbabwe	0.915		8	Suriname	0.897	
4	Vatican	0.908		9	Swaziland	0.896	
5	Poland	0.903		10	Uruguay	0.894	

HT le Gitt

https://twitter.com/amazingmap/status/1548430351604727814?t=7vI-gNBjbqF7OBnda6kpLg&s=19

Click here to subscribe to am/FX