What to focus on in Global Macro for the week of May 16th, 2022

"When the Fed slams on the brakes, someone always goes through the windshield."

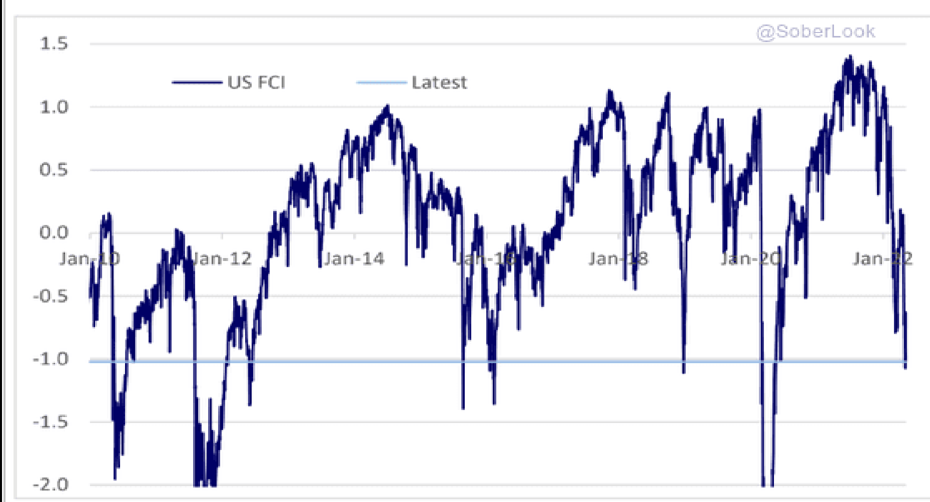
This version of the old adage is attributed to former Federal Reserve Vice Chair, Don Kohn.

We have seen this quote come to life in various forms over the last few weeks as liquidity starts to recede.

DB's research team made the following comment regarding their shadow rate "...our shadow fed funds rate currently stands near 2.3%, which is 2.8 percentage points higher than its level six months ago. This nearly three percentage point rise in our shadow rate over the past half-year, which reflects not only the Fed's tightening moves but also their balance sheet decisions and guidance about future policy, is the sharpest rise in this metric since the Volcker Fed in 1981".

Essentially, they argue that the Fed has already gone a long way in re-positioning policy (via market rates), US financial conditions have tightened substantially in recent weeks. Strong USD, weaker equity, and weaker IG and HY bonds, equal a sharp tightening of financial conditions. That is of course exactly what the Fed has been looking for.

Figure 5: Some US FCIs are at levels that have led to a dovish Fed in the recent past



Source : Deutsche Bank, Bloomberg Finance LP

Notice, that over the last 30 years they rarely stayed much tighter than current levels for long, other than during the GFC. Also, notice how during the inflation prone 70's and 80's financial conditions were much tighter on average, reflecting higher interest rates, weaker equities, and wider credit spreads. If we are shifting to a regime with higher and more persistent inflation, expect a similar backdrop to evolve over time.

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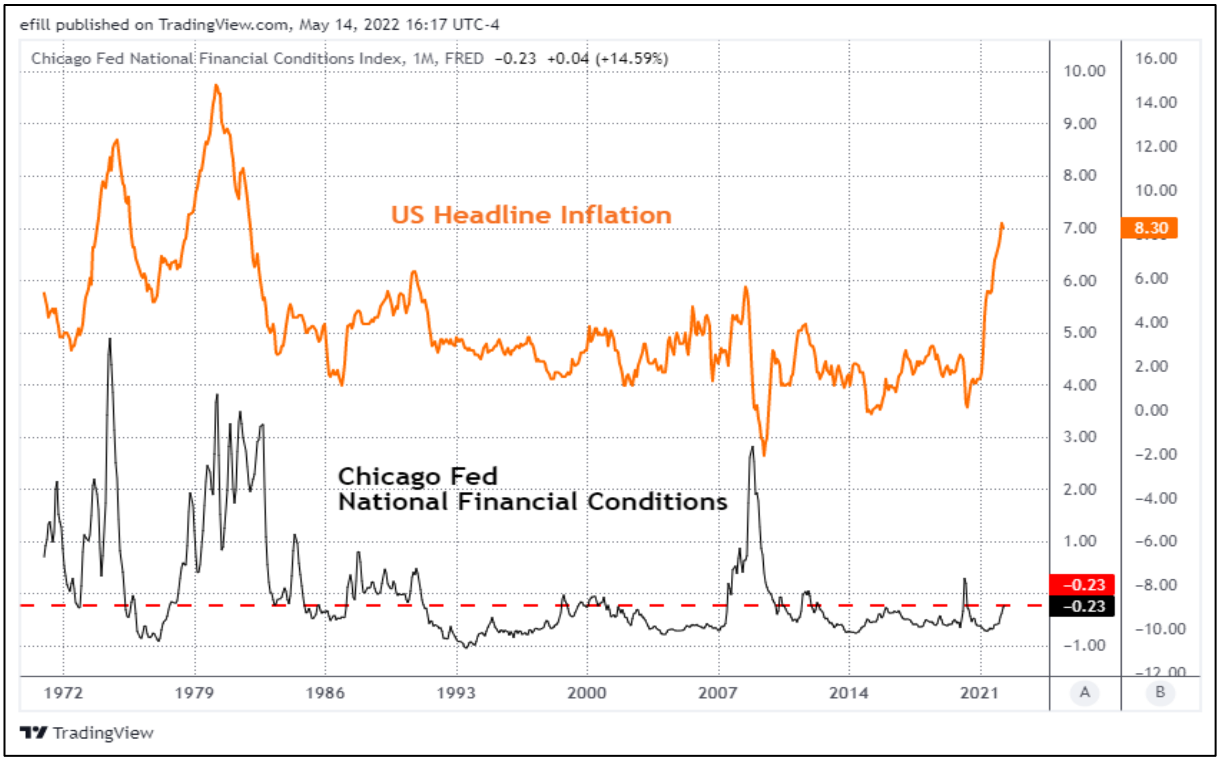
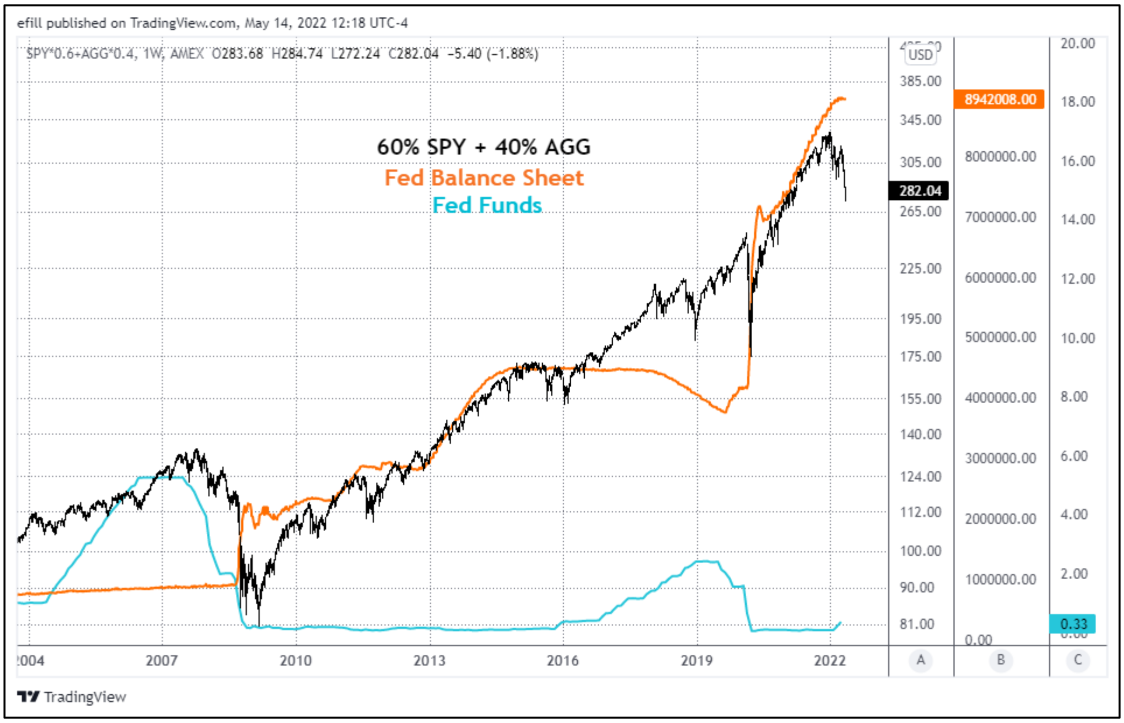
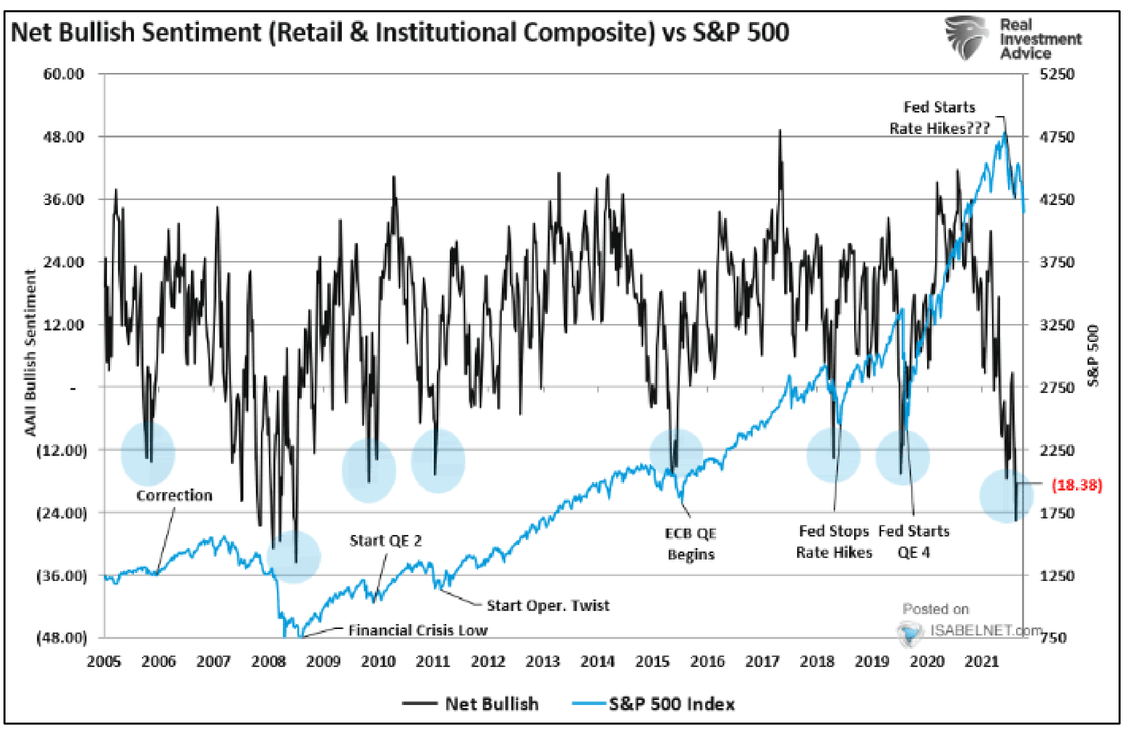


Here is another version of financial conditions via GS. The rate of change matters.

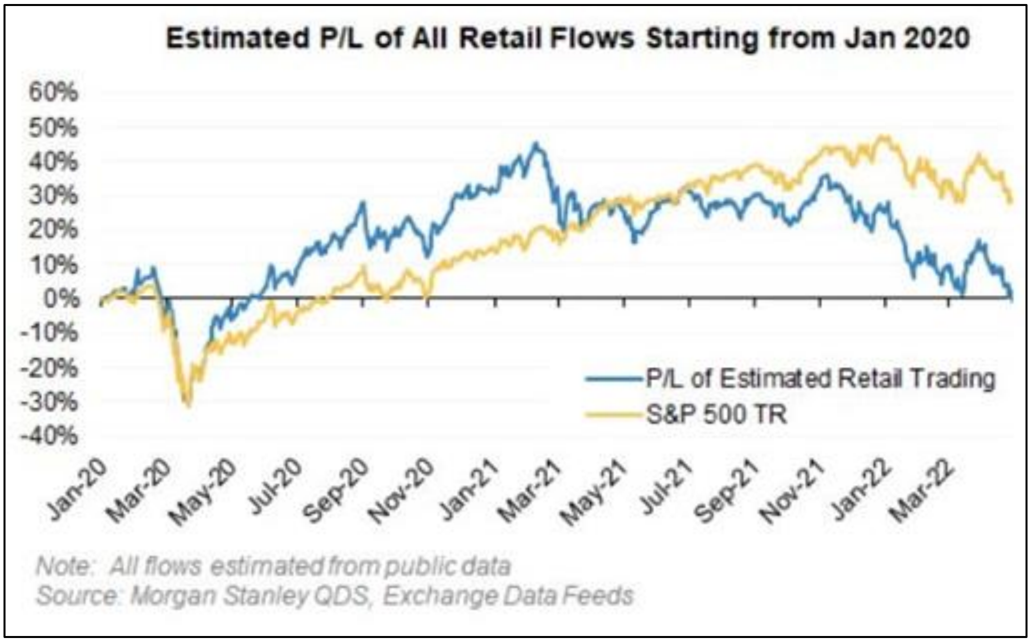
With no place to hide, investors have felt the pain across markets. In the past, this kind of stress has led to a pause or the end of a tightening cycle. Not this time. This time it is a policy goal. Ironically, some softer economic data would likely be positive for the markets in the short term.



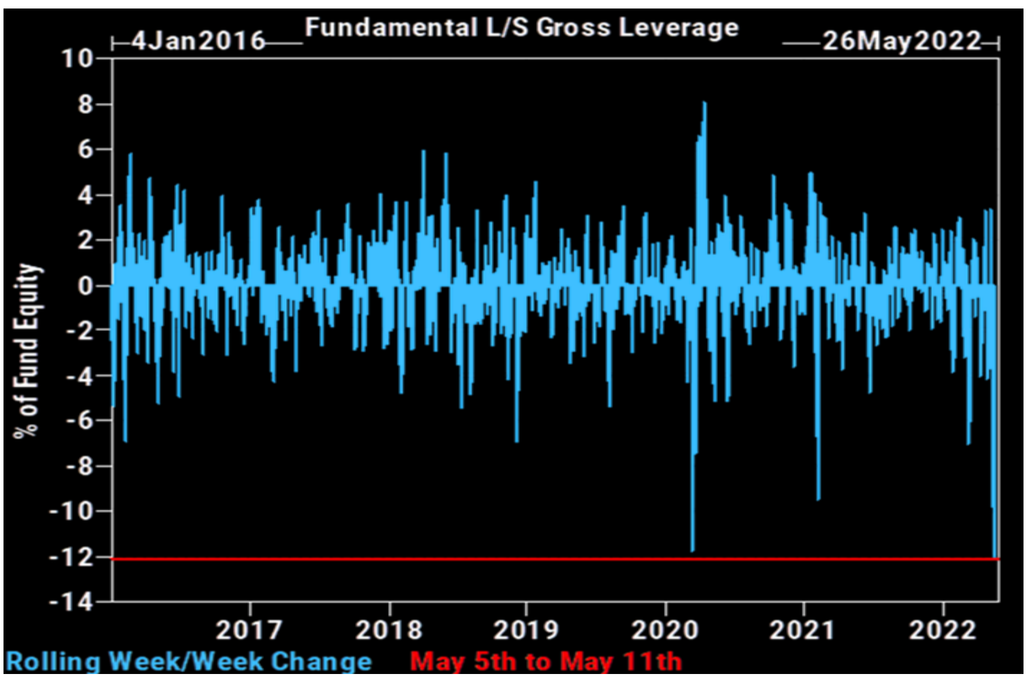
The weak markets and foreboding macro backdrop have crushed sentiment.



Retail investors have seen the profits of the last two years largely evaporate.



Institutional investors have continued to cut exposure… *"Fundamental L/S Gross leverage saw the largest 5-day reduction on our record, driven by mark-to-market as long losses have far outweighed gains from short positions"* (GS Prime Brokerage)



Markets have the feel of being washed out at this point. We will see if Friday's price action kicks off a tradeable rally or not.

Here is BoA's 2-cents on the subject…

Are We There Yet? No…fear & loathing suggest stocks prone to imminent bear market rally, but we do not think ultimate lows have been reached, nor ultimate highs in yields. BofA "capitulation" checklist using today's data vs COVID '20, Euro-debt crisis '12, GFC '09, tech bubble '01 data at the lows:

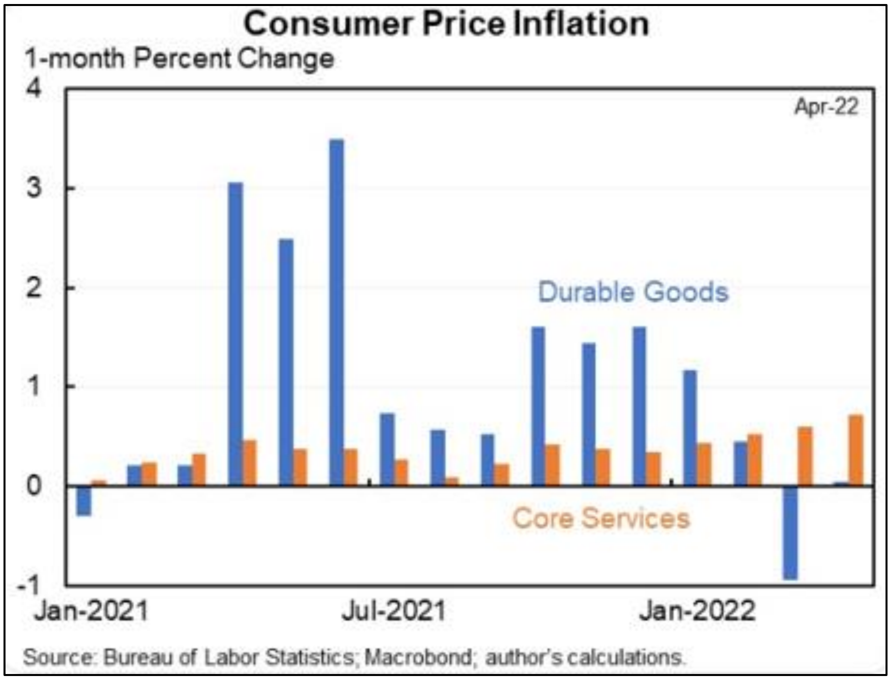
- *cash level 5.5% of AUM…**capitulation***
- *growth expectations net -71%…**capitulation***
- *profits expectations net -63%…**capitulation***
- *rate expectations net +86%...**no**…rate cut expectations always seen at lows*
- *equity AA net +6%…**no**…lows require -20-30% allocation (i.e. investors UW stocks)*
- *bond AA net -68%…**no**…lows require investors to close their UW bond allocation*
- *private client equity AA 63%...**no**…prior lows saw equity allocations pullback to at least 56%*
- *Equity inflow unwind…**no**…for every $100 inflows past few weeks we have seen just $4 redemptions vs >$50 in prior bear markets*
- *Equity redemptions % AUM….**no**…outflows thus far 0.2% AUM vs 3-6% at prior lows.*

The above sounds sensible and may prove to be correct, but the danger is that it is yet another playbook that may or may not be applicable in the current environment.

The longer-term question for markets is whether we are truly in a new, more inflationary regime, or not. Everyone's frame of reference is based on what the backdrop has been for the last 20-years and the way the Fed and markets have interacted as a result. All the investor playbooks are based on the "usual" outcomes we have seen during this period. In a generally disinflationary environment, the economy is susceptible to deflationary shocks, but in an inflationary environment, it becomes susceptible to inflationary shocks. The markets and the economy have become used to a Fed that is always there to bail them out with liquidity. For now, at least, that is not the case. If a true inflationary regime change has arrived, markets will need to get used to doing their act without the safety net they have become accustomed to.

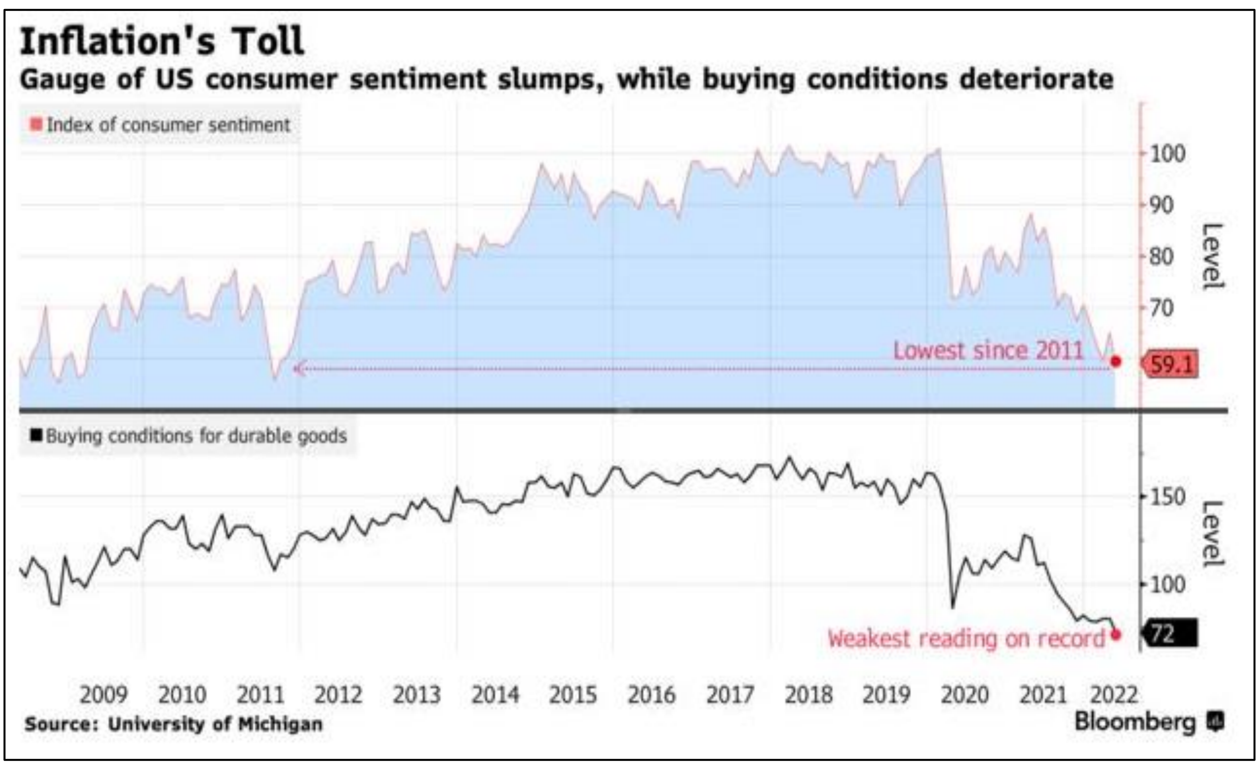
Whether inflation turns out to be the real thing or just a paper tiger, the reality at the moment is that the Fed and the administration are laser-focused on fighting it. Unfortunately, they are late and therefore out of sync, making the outcome very uncertain. If you are racing to catch up, it increases the probability that you zig when you should zag.

While we are getting the long-anticipated slowing in goods prices, services are a larger part of the CPI calculation. Core service inflation has increased for four straight months now. Luckily for the Fed, services are also a component that can be quickly and directly affected by demand destruction triggered by tighter financial conditions for consumers.



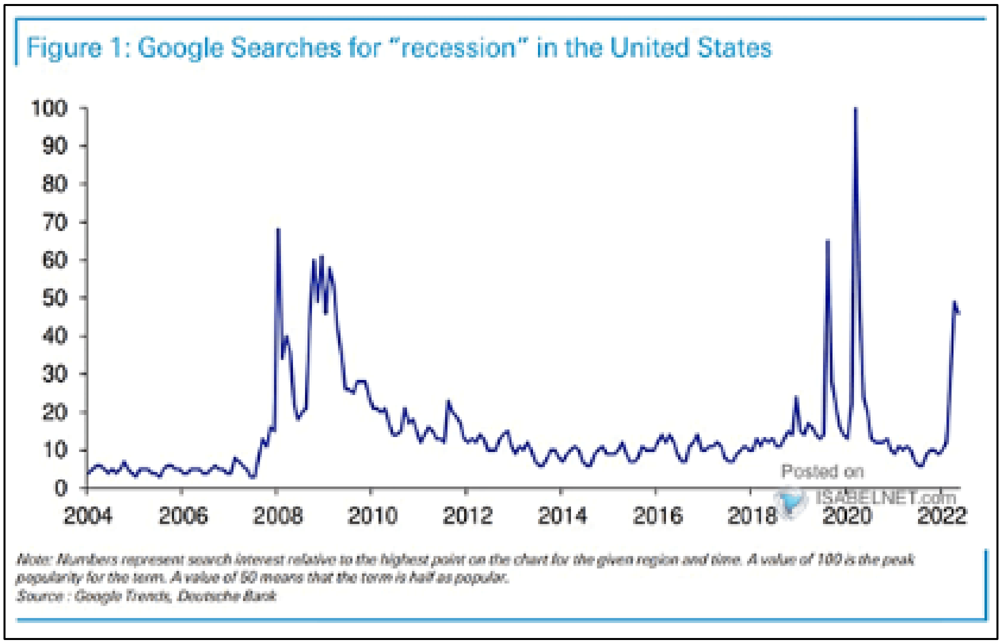
Source: @jasonfurman

In the meanwhile, high prices and falling real wages are starting to take a toll on consumers.

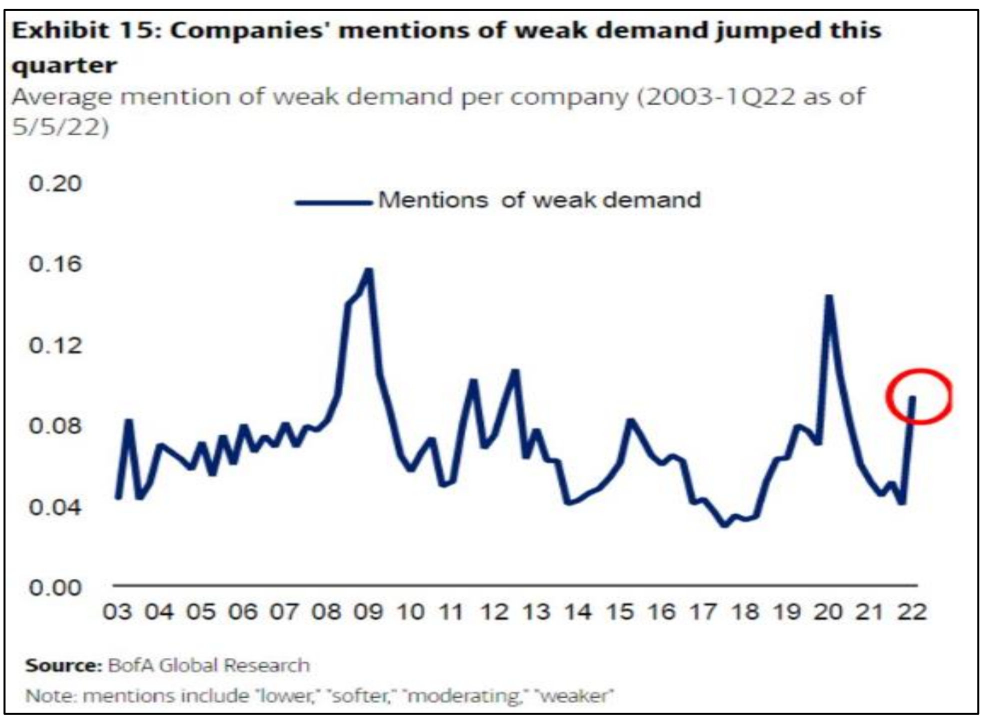


Nearly half of respondents in the most recent survey don't expect their incomes to keep pace with inflation over the next 12 months.

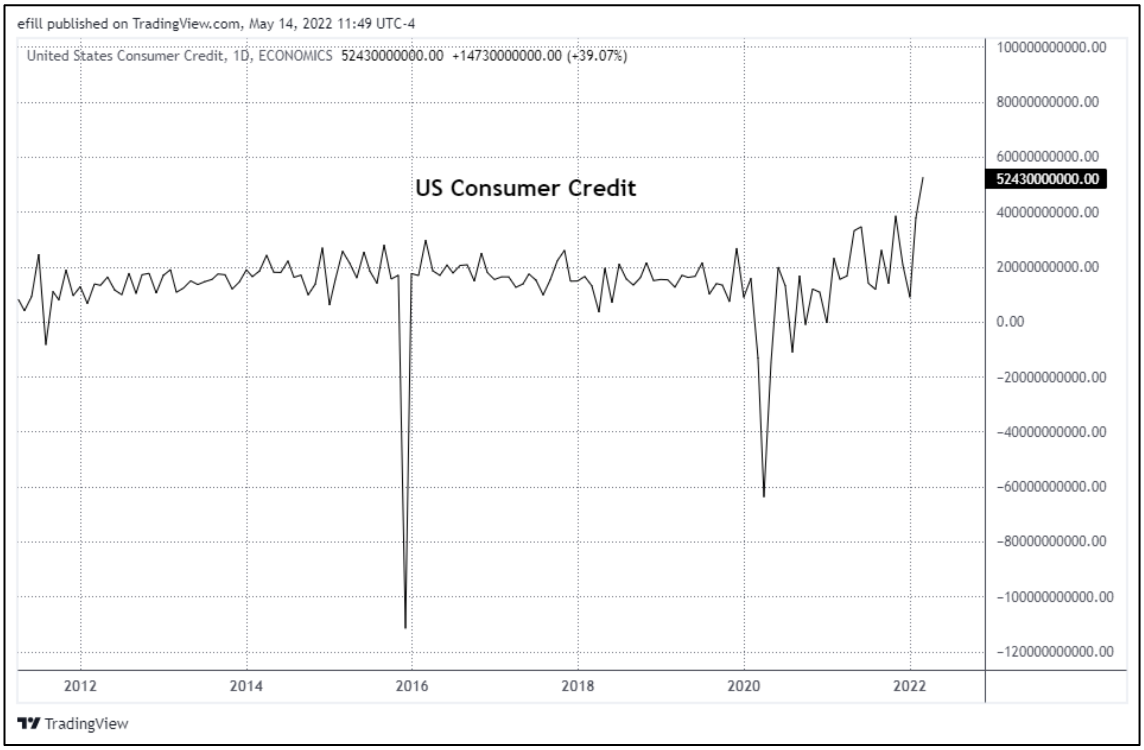
The possibility of a recession is increasingly on people's minds.



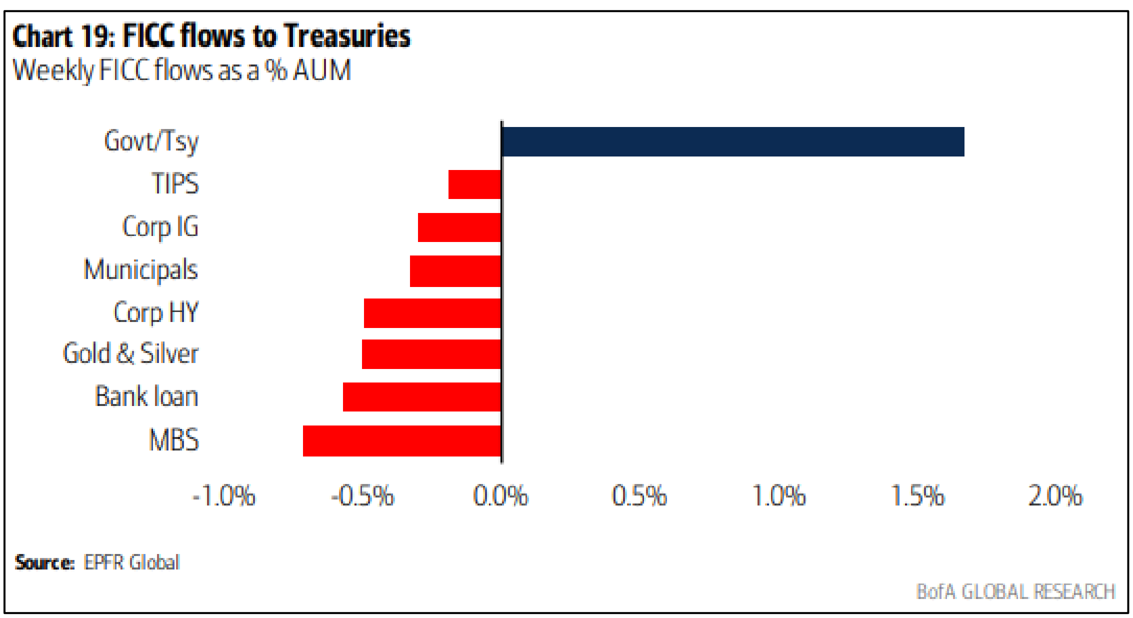
At least some companies are starting to see weaker demand…



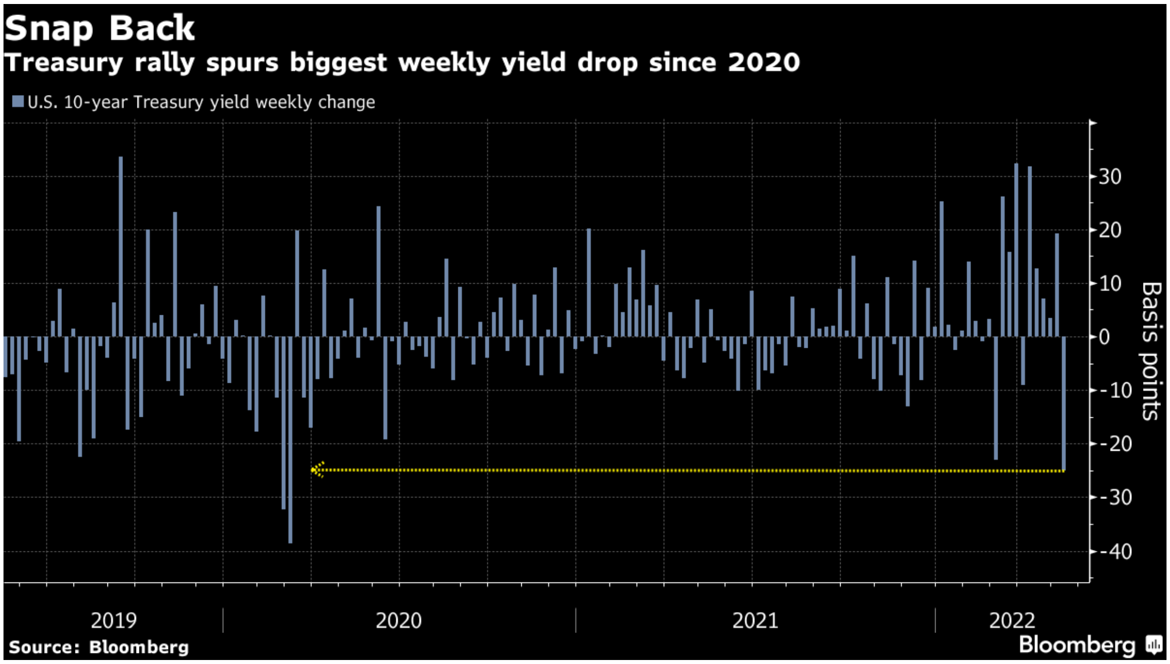
Consumer credit has been rising recently as revolving credit lines are drawn on. While it is worth watching, it is not yet something to worry about as consumer debt as a percentage of disposable income remains very low on a historical basis.



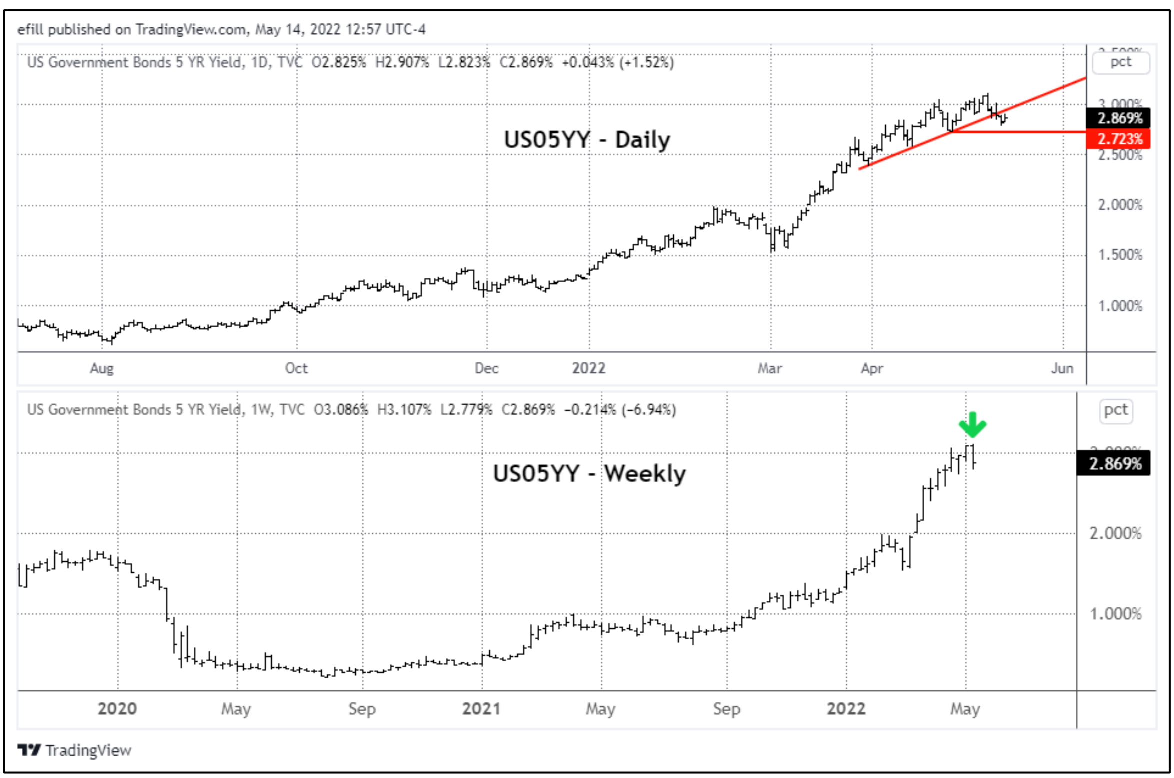
Last week we saw the pain in markets and the rising recession fears get to a point where money started to flow back into Treasuries.

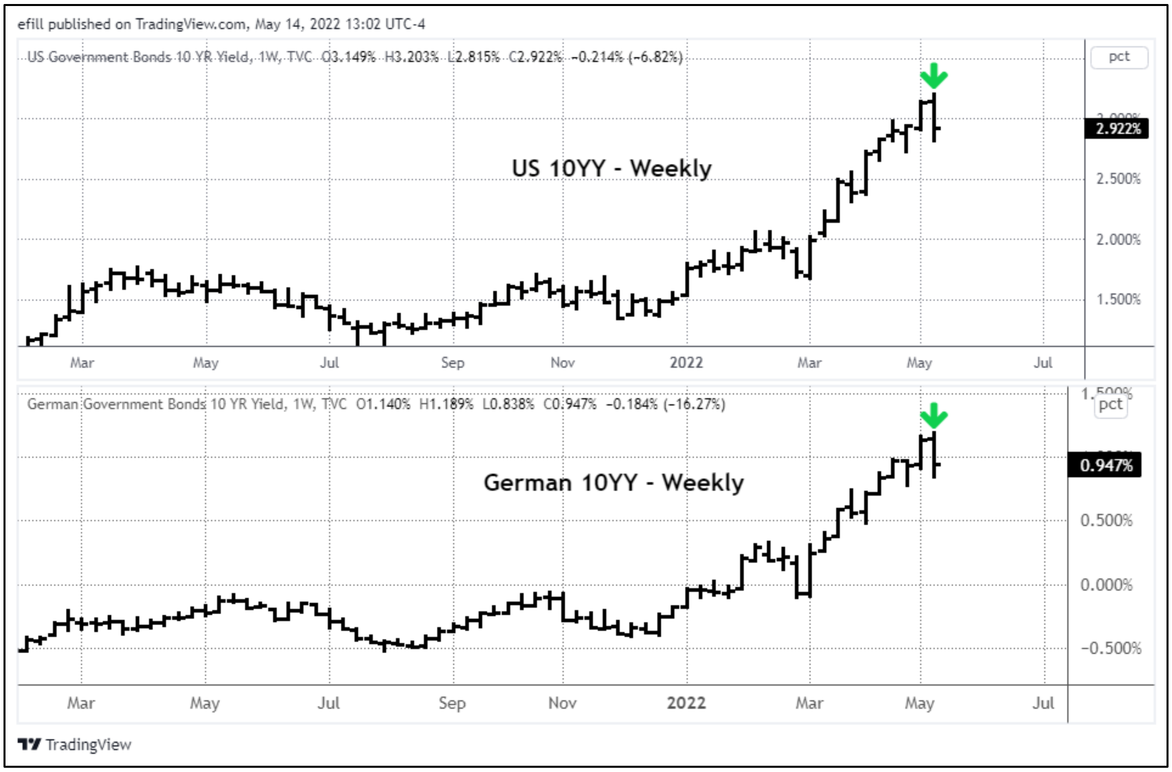


The resulting drop in yields was meaningful.



We will see if it lasts, but at least for now, yields have lost momentum on the upside. Weekly yield charts show outside reversal weeks in US 5's and 10's. Even German Bund yields had a reversal week.





Worries about global growth and especially the situation in China and Europe have been weighing on various industrial commodities. Copper is now at the bottom of its year-long range.

Strong fundamentals in energy have how so far shielded prices from much of a drop. So far, demand destruction has not been able to overcome the lack of supply.

Further increases in energy prices will make it almost impossible for the Fed to engineer anything close to a soft landing so the price action in these commodities is critical for the whole economy.

This Bloomberg article is a nice summary of some of the issues we are seeing in refined products:

[Gasoline, Diesel, Jet Fuel Refining Capacity Is Too Low in the US to Meet Demand - Bloomberg]

"We are on the razor's edge," said John Auers, executive vice president at Turner, Mason & Co. in Dallas. "We're ripe for a potential supply crisis."

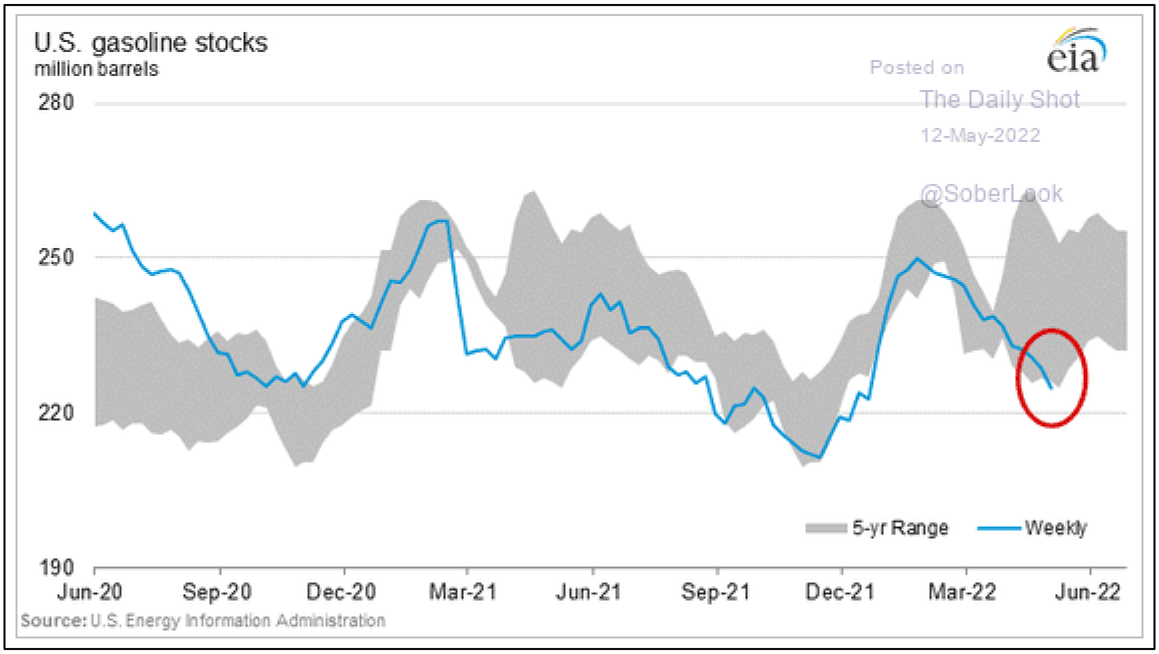
The dearth of refining capacity has dire implications for both US consumers and global markets. At home, retail gasoline prices continue hitting new records, exacerbating some of the worst inflation American households have ever seen. Meanwhile, the East Coast is on the brink of a diesel shortage that risks crippling already strained supply chains that have disrupted the flow of everything from grocery staples to construction supplies in the last two years.

The factors fueling the refining shortage won't surprise anyone: With demand for gasoline and jet fuel practically vanishing during the height of the pandemic, companies closed some of their least profitable crude-processing plants permanently. Some of those plants had been affected by fires, explosions and hurricanes and were just too expensive to fix, especially because an eventual transition toward cleaner energy makes their long-term business model unprofitable and makes them less likely to attract buyers.

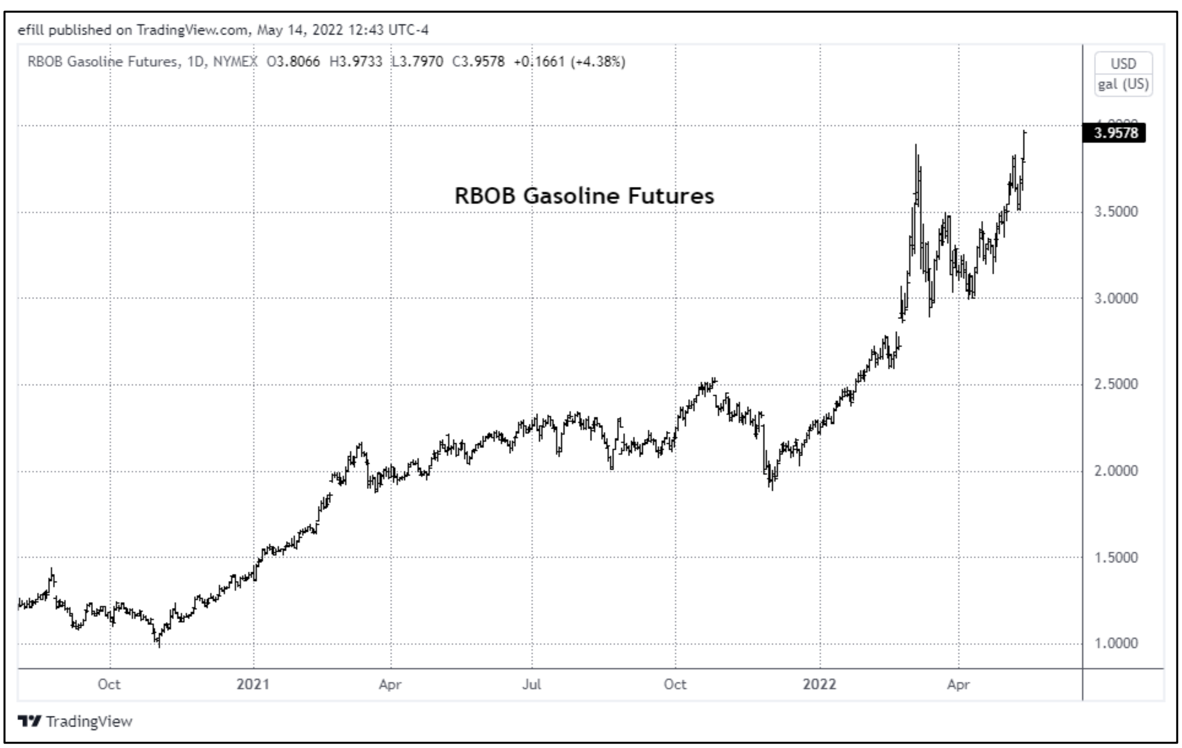
At the same time American refining shrinks, the war in Ukraine has made the global divergence between supply and demand even more acute. With many countries shunning Russian fuel exports in the wake of the war, the US is now supplying more of the world's fuel with an ever-shrinking fleet of plants. Europe has been seeking alternatives to Russian diesel since the war began, while fuel demand in Latin America, the largest buyer of US refined products, is strong and growing. Meanwhile, the US is itself gearing up for a spike in consumption this summer.

In other kinds of markets, a surge of demand and shortage of supply would trigger more investment, especially with such swelling cash hordes. But the longer-term transition away from fossil fuels dims the outlook for demand, making companies unwilling to put up the billions of dollars needed to build new plants. Even resurrecting idled plants can be prohibitively costly at a time when construction and labor costs in the U.S. are booming. With California unveiling this week a roadmap to slash oil use by 91% from 2022 levels by 2045 and other places moving to limit fossil-fuel use in the decades ahead, refining companies and their investors can see the writing on the wall.

"Nothing about the current environment is promoting investments in fossil fuels," said Bloomberg Intelligence analyst Fernando Valle. "It's a 15 to 20 year payback on most of these investments."



Given the above, it isn't surprising that gasoline is hitting all-time highs. This is scary stuff for the Biden administration as the midterm elections approach and is why Biden last week suggested the Fed needs to do whatever it takes to get inflation down. Watch energy prices over the next few weeks. If they head higher while recession concerns are on the rise, it is going to be a real test for the Fed and markets. Shortages, should they develop, will cause panic in Washington.



Although it backed off a bit on Friday, the dollar remains much stronger than most had expected. I still think the combined effect of higher rates, a strong dollar, and high energy/inflation could prove much more toxic for the economy than is expected.

Again, the playbook has failed people this time.

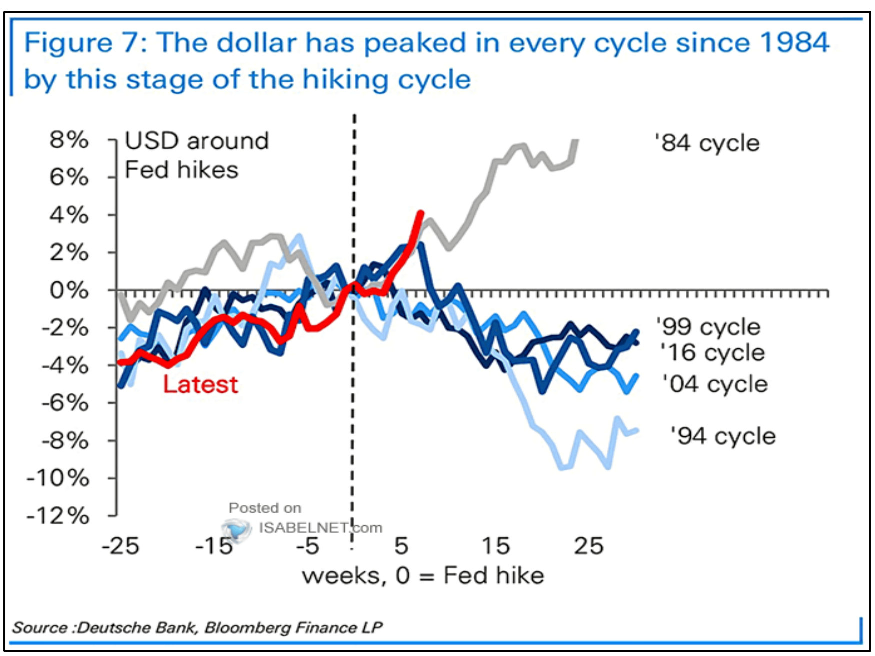


Figure 7: The dollar has peaked in every cycle since 1984 by this stage of the hiking cycle

Source :Deutsche Bank, Bloomberg Finance LP

The combination of general position liquidation, still high rates, and a strong dollar have proven to be too much for Gold to bear. This is an ugly break. We will need to regain 1860 quickly to salvage any chance of a near-term rally.

Crypto

The crypto crash we have seen over the last few weeks is still working its way through that ecosystem.

The demise of Terra/Luna has not only been expensive but has woken up regulators. Last week US Treasury Secretary Janet Yellen mentioned it specifically, calling for new regulation of the industry and particularly "stable coins".

In total, $1.8Trl has now been wiped off the high water mark back in November of last year.

Headlines regarding China's lockdowns and economic data are well worth watching out for, as are the articles on Putin having terminal cancer that are increasing in frequency. Putin being suddenly incapacitated would be a very positive event for markets.

Important Macro Data Releases and Events for the Week

Monday 5/16/2022

- Sunday night ET - Retail Sales and Industrial Production (Apr)
- BoE Monetary Policy Report Hearings
- RBA Meeting Minutes

Tuesday 5/17/2022

- Employment Date (Apr)
- GDP (Q1)

	Retail Sales (Apr)
	ECB's President Lagarde speech
	Fed's Chair Powell speech
Wednesday 5/18/2022	CPI and PPI (Apr)
	HICP (Apr)
	Housing Starts & Building Permits (Apr)
	CPI (Apr)
	Trade Data (May)
Thursday 5/19/2022	ECB Monetary Policy Meeting Accounts
	Initial Jobless Claims
	Initial Jobless Claims 4-week average
	Continuing Jobless Claims
	Philly Fed Manufacturing Survey (May)
	PBoC Interest Rate Decision
Friday 5/20/2022	Retail Sales (Apr)
	Consumer Confidence (May)

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