August 12th, 2020

MARKETS
Three things…

- The UK reported today that GDP rose 8.7% in June, well above consensus of +8.0%. However, that good news did little to soften the blow that GDP contracted 20.4% in Q2, a record collapse. This is also remarkable when compared to its peers. No other EU member (or former member) has reported a similar sized decline. And this is twice the fall reported by the US. However, the markets looked on this as good news wrapped in really bad news. The TREND improved dramatically in June, so traders are focused on that. The Pound held steady at $1.3050. Short-dated gilt prices are higher, rates lower, as the quarterly collapse prompted some anticipation of new stimulus. Lastly, the FTSE is the biggest winner, rising more than 1.5% on the news.
- The US yield curve steepened further today, as a string of market events combined to lift rates higher. The first is Russia's claim yesterday it had developed a Coronavirus vaccine, which gave markets an early session boost. The record sized $48 Bln 3-year auction added to rising yields in the longer end of the curve, as traders lightened positions to pick up the shorter duration security. Despite the record size, however, yields were a record low 0.179%. In the risk-on market today, that yield inched up towards 0.20%, while also lifting rates across the board. Today's record $38 Bln 10-year auction is adding to that rise. Lastly, today's CPI pushed 10-year yields quickly to a 1 one-month high 0.69%.
- Speaking of which, July CPI rose 0.6% mkt +0.3%), boosted by steep increases in airfares (+5.4%), gasoline (+5.6%), transportation (both purchase and maintenance +2.9%) and clothing (+1.1%). Food prices dropped 0.4%, the first decline since April 2019, dragged lower by an 8.2% plunge in beef prices. Excluding food and energy, Core-CPI also rose 0.6%, the steepest monthly increase since January 1991. For the year, CPI rose 1.0%< while Core CPI trended higher, rising 1.6%, after last month's 1.2% increase. We want to see Inflation somewhere around

2.0%, but this suddenly steeper rate of increase may be troubling to the Fed, and to markets.

FOREIGN EXCHANGE

The dollar is little changed overnight with the DXY dollar index trading at 93.60. Markets are still trading with a risk on tone, but with a more pro cyclical mix as US Treasury rates have begun to rise. The Scandinavian currencies are trading stronger against the dollar on the back of higher than expected inflation in Sweden along with the continued drift higher in oil prices. The dollar has fallen sharply in July by around 5% and though that doesn't sound like much it is the largest monthly decline in 10 years. There has been talk that the strategic rivalry between the US and China is reducing the demand for US dollars as a reserve currency. In fact, Russia and China have both expressed a desire to move away from the dollar. However, in the near and medium term there just isn't any viable alternative to the US dollar. Traders have been paying attention to actual inflation and also increasing inflation expectations. This is reflected in the steepening of the yield curve where the 2 -10 yr. spread has risen by about 10 bps to 51 bps currently. Inflation expectations in most countries have risen; particularly in the US, over the past month or two and since nominal yields on US Treasuries have remained low, this has resulted in a drop in US real rates, which has weighed on the dollar. The Fed has in its comments said that it would allow inflation to rise above its target before embarking on any tightening, due to the fact that inflation has been below target for such a long time. Stimulus talks remain unresolved as the White House looks for other measures that can be done through executive order. This increases the odds that a near term congressional deal are fading and result in a weakening dollar. The Chinese yuan is trading at 6.9340. Chinese stocks sold off with the CSI 300 down 2.5% and the tech heavy ChinNext down 3.9% after credit growth slowed more than expected and concerns remain about tension with the US. The slowdown in credit growth confirm market expectations that the PBOC will take a more balanced approach to controlling total liquidity in the months ahead. Emerging markets are doing better against the dollar except for the Turkish lira which gave up all of yesterday's gains and is trading at 7.3200, down 1.5%. President Erdogan on Monday called for further interest rate cuts so that investors can invest in Turkey. This is more likely to scare investors as the possibility of capital controls now seems as the only way to keep the currency at bearable levels. Gold recouped some of its losses from yesterday; rising $26 to $1937, while the 10 yr Treasury yield is trading at 0.666%

- The Reserve Bank of New Zealand increased its QE program from 60 bln to 100 bln NZD and extended the program by another year. The policy committee said the reason was because of higher rates and more issuance recently and said the purchases could be front loaded. The statement also said that the central bank needed to prepare for additional easing measures including negative rates. For the moment the increased QE is intended to drive rates lower while the head of the central bank pointed out that the currency does not appear to be out of whack with fundamentals. The RBNZ's macro forecasts continue to underscore that

risks are skewed to the downside. The central bank's decision comes shortly after NZ reported its first cases of community spread from corona virus after more than 100 days without reporting a positive case.

- The British pound is trading around 1.3050 little changed from Friday. The UK economy fell by 22% in the 1st half of 2020 almost double the decline reported in the US and larger than any of the declines reported by any EU member state. The underperformance is blamed on the UK's greater reliance on consumer services spending and the high level of labor participation by working parents. Many of them have left work to look after their children. These are structural disadvantages and likely mean that the UK economy continues to lag behind. Of course there is a lot of uncertainty with these off the chart numbers. From the pre-virus peak in Feb through the bottom in April GDP contracted a cumulative 26%. As lock downs were lifted, GDP began to recover rising 2.4% m/m in May and 8.7% m/m in June. These are backward looking numbers and momentum since the lockdown and improvements should continue into the 3rd Q. The B of E which has toyed with the idea of negative rates may look to increase monetary easing as a result. A hard Brexit is still in play and could provide more ammo for easing, initial expectations are that the B of E will increase its asset purchases by 100 bln pounds in Nov.

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