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'She cannae take anymore'

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The S&P 500 is approaching a 10% draw down from its recent high as financial conditions are squeezed by tighter monetary policy, plunging monetary aggregates, and a resurgent dollar. As we pointed out two weeks ago, the liquidity tanks are draining, and the resultant dollar shortage reminds us that it might be their currency, but it is our problem.

Dollar-denominated debt and energy have become more expensive. Although most major BRICS nations are well prepared, many weaker developing countries face economic hardship as energy-related current account deficits get out of control. The list of nations waiting for triage at the IMF and World Bank grows weekly.

Although partially protected by their ability to print their own currencies, the developed nations of Europe and Japan move closer, albeit more slowly, to the same financial cliff edge. Rising bond yields with looming maturity walls constrain government, business, and consumer spending plans. The abandonment of HS2 is not an isolated example. The US has so far been unscathed by exporting the negative consequences of running high levels of deficit funded spending. However, the bond market vigilantes are now even calling this into question.

Just as the Fed and BoE paused two years of non-stop rate hikes as inflation eased, the large fiscal deficits of the major developed economies have reared their ugly heads and bond markets have puked at the prospect of increased supply. The US Treasury must find buyers of more than $2tn Treasury bonds a year until decade end to meet the requirements of the Chips Act and the Inflation Reduction Act, not to mention the cost of the military support of Ukraine. Draining the reverse repo tank will mop up a few more shorter duration T-Bills, but households, pension funds, and insurance companies must buy more longer duration Treasuries.

Financial markets are deep into "good news is bad news" territory. This week's stronger than expected US manufacturing survey and upwardly revised job openings data have fuelled the well-rehearsed "necessary multiple further hikes" rhetoric of the FOMC and MPC. Investors would welcome the relief of sharply higher unemployment number. With the critical non-farm payrolls released as we publish this letter, it is no longer just the Fed and the BoE that want you to lose your job. Until the central banks decide it is time to release the pressure valve, the bond vigilantes are back in Dodge and controlling the direction of financial markets. Debt everywhere, particularly the longer duration variety, has been downgraded.

Amidst this turmoil the sharply inverted yield curves of the last eighteen months, the traditional indicators of impending recession, are flattening out. And it is worth remembering that Jay Powell acknowledged in his Jackson Hole speech that current policy rates are above the theoretical R* equilibrium. So, despite the coordinated rhetoric of higher for longer and multi--ple further hikes, we are in the territory where something will break unless the monetary release valve is opened. The rivets on our financial market machinery are starting to pop. Picture Jay Powell as Captain Kirk. His Chief Engineer, "Scotty" Scott, berates him, "I'm giving her all she's got, Captain! She cannae take anymore."

However, Powell and the other central bankers have dug themselves into a hole over inflation targeting and two recent examples from the energy market illustrate how fragile some of our most vital supply chains have become. In July, Saudi Arabia announced plans to reduce oil production by a million barrels a day, about 1% of global consumption. The price spiked by over 30% in the following weeks.

Meanwhile, a military coup in Saharan Niger halted the supply of about 5% of the world's annual Uranium production. The spot yellow cake price (the raw material that feeds the world's nuclear reactors) rose 28% in the following 12 weeks. These are not isolated instances, but examples of how a fracturing global trading system can bring forth commodity price volatility and structurally higher levels of inflation. The changing trajectory of the world's bond markets is saying that we have reached the point where demand management can no longer fix things and supply-side reforms, an overlooked aspect of the UK's policy debate since Liz Truss and Kwasi Kwarteng disappeared in a cloud of smoke this time last year, must be re-examined.

As we head into an election year in the UK and the US, expect a reprioritisation of supply side policies. Joe Biden's re-election could rest on the potential for a rapprochement with Saudi Arabia. To this end Joe and MBS must replace their last cursory fist bump with a hug. Joe needs lower pump prices, and MBS wants weapons, security, and respect. However, this is no pushover. China is Aramco's biggest customer and has an appeal among the Kingdom's secret police with superior surveillance technology and a track record in social control.

In the UK, the sanctioning of the North Sea Rosebank development, the stepping back from some of the more restrictive green policies and proposals to deregulate our primary capital markets can hopefully be seen as merely the first steps in more widespread proposals for growing the economy. For now, though, the bond vigilantes are running the show and seem determined to make something break.

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JACKSON'S CHART - JAPAN 10Y (MONTHLY)

An analysis by Jackson Wray

Image Source

EXPLANATION

Japan 10Y (Monthly) - Since 2007, the Japanese 10 year had been in a downward channel until the breakout in 2018. Following a retest of the -2.80% level, which was also the location of the trendline retest, this chart has been moving north quite aggressively. A double bottom formation at support can strongly indicate the next move, in this case, constructing an upward channel, recently breaking above the key 0.55% level. The move to the critical area of 0.870% -0.925 % continues, an area we have seen activity in the past, albeit 10 years ago.

Jackson's analysis indicates how Japan, the last global anchor to the world of QE and yield curve control, is slipping its mooring. Being so yield-starved for so long, Japanese investors have been significant buyers of US Treasuries. As JGB yields rise, this source of US dollar funding becomes more difficult.

FURTHER READING & LISTENING

- Why hugging the Saudi heir makes sense
- Bond selloff threatens hopes for economy's soft landing
- The global economic outlook, or why "higher for longer" won't last
- The nuclear option
- Luke Gromen: Panic in the bond market will continue unless oil or dollar relent
- Credit Picker's market with Wayne Dahl, Robert O'Leary, and Mark Jacobs

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06/10/2023	Value	YTD (%)
FTSE 100	7440.58	-1.75
FTSE 250	17573.02	-8.79
S&P 500	4258.19	10.52
Gold $/lb	1820.06	-1.52
Brent Oil $/bl	90.78	-5.14
Copper $/lb	3.58	-4.28
UK 10 yr yld	4.55%	24.44
US 10 yr yld	4.73%	21.99

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