

ON DECK FOR THURSDAY, JULY 8

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	07-08	08:30	Initial Jobless Claims (000s)	JUL 3	400	350	373
US	07-08	08:30	Continuing Claims (000s)	Jun 26	3,300	3,350	3,339
US	07-08	15:00	Consumer Credit (US\$ bn m/m)	May	--	18.0	18.6

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KEY POINTS:

- Risk-off sentiment but with the ECB capping a bond rally
- Some narratives for the bond rally are misguided and premature
- The ECB's strategic review: It took 20 months to do that?
- FOMC Minutes: upside risk to inflation projections
- Japan may add more fiscal stimulus as Tokyo declares emergency
- Virus warnings spread, but grossly premature to ring alarms
- Chinese bonds catch up to RRR cut talk
- LatAm inflation: only Chile mildly surprised
- Negara stays on hold, Peru to do likewise
- Light releases

Sovereign yields continue to decline but have somewhat reined in steeper declines that were in place before the ECB announced the conclusions of its strategy review. That's probably because the ECB took a more mealy mouthed approach to inflation overshooting language that rendered it largely ineffective compared to the Fed's revised goals statement last August. Incremental developments are captured below including a summary of the ECB's strategy review and a recap of yesterday afternoon's FOMC minutes.

US 10s had dipped to 1.25% earlier this morning but have cheapened up by about 5bps to 1.3% since the ECB's review. EGB yields have reversed earlier moves with Italian and peripheral spreads widening over bunds after the ECB's communications. The dollar is slipping primarily against the euro and other safe havens like the yen and franc, but gaining ground against most other major crosses. Stocks are off by 1–2% or so across N.A. futures and European cash markets.

I see a lot of media headlines on how markets are abandoning growth expectations and the reflation trade with more dovish central banks as justification for the bond rally which all seems extraordinarily premature, ill-advised and a fundamental misinterpretation to me. Most regions of the world are still seeing very low COVID-19 new case rates, the Fed minutes keep them on track with taper guidance, the ECB rejected following the Fed on average inflation targeting and it seems absurd to suggest the curve is pricing away a recovery and return to sharp downside risks to growth and inflation as economies generally remain on reopening paths. Beyond what I wrote yesterday morning about market drivers mainly in terms of liquidity and relative scarcity issues that are significantly centered around the US debt ceiling adjustments, there were few material overnight developments:

- Tokyo declared a new state of emergency over the pandemic and is banning spectators at the upcoming Olympics on July 23rd;

- The number two in Japan's Liberal Democratic Party—Secretary General Toshihiro Nikai—indicated support for further fiscal stimulus of about ¥30 trillion (~US\$275B) to counter the virus effects.
- France warned on travel to Spain and Portugal and the WHO warned on reopening too quickly.
- China's bond market caught up to earlier headlines on potential cuts to the required reserve ratios. The headlines hit yesterday morning in the N.A. session but China's bond market reacted into their following day in the overnight session by pushing the whole curve down by 5–9bps.

Overnight releases through this morning were pretty light. German exports grew at a slightly softer than expected pace (0.3% m/m, 0.6% consensus) while imports soared by 3.4% (0.4% consensus, prior -1.7%).

Negara kept its policy rate unchanged at 1.75% as universally expected while emphasizing downside risks.

US weekly initial jobless claims have resumed a downward trend. After a couple of weeks of readings over 400k in June, the past two weeks have dipped to the low 370s again.

Three LatAm countries updated inflation figures and only Chile mildly surprised to the downside. Mexican inflation landed on the screws at 3.9% in June. Brazil's inflation rate also matched expectations at 8.4% y/y, setting aside the quirky regional tendency to focus on made-up figures to the second decimal point! Chile's inflation rate climbed by less than expected to 3.8% y/y (3.6% prior, 4.1% consensus).

Peru's central bank is universally expected to stay on hold tonight (7pmET).

ECB'S STRATEGY REVIEW

The ECB generally met expectations when it released the results of its strategic review this morning. The main release is [here](#). The revised monetary policy strategy statement is [here](#). A separate release explaining the inclusion of climate change into monetary policy considerations is [here](#).

There are three main points worth emphasizing. Markets reacted by pushing Italian and peripheral spreads a touch wider over bunds. That could be because the language around overshooting the inflation target was so mealy-mouthed as to be largely pointless.

Inflation Targeting

President Lagarde's press conference clearly stated that the ECB is not embracing Fed-style average inflation targeting. That defied yesterday's headline head fake and explains why the sovereign debt rally earlier this morning began to reverse after the ECB communications and during her presser.

Points 5 and 6 in the aforementioned strategy statement are the relevant parts. They embraced a symmetrical 2% inflation target over the medium term as a replacement for the prior targeting framework that aimed for inflation "close to, but below, 2 percent."

The overshoot language was weak. The Fed's revised Statement on Longer-Run Goals and Monetary Policy Strategy that was released last August ([here](#)) said that following periods in which inflation undershoots, policy "will likely aim to achieve inflation moderately above 2 percent for some time." The ECB—in classically European fashion—said that following periods when policy has been around the effective lower bound it "may also imply a transitory period in which inflation is moderately above target." The Fed's language was more definitive compared to the ECB's "may" but the ECB's language was probably necessary in order to keep the relatively more hawkish northern central bankers on side.

How meaningful is this shift at the ECB? Not very. Perhaps not at all. The ECB is already onto a symmetrical approach in theory and the key lies in the implementation and ability to steer and control inflation in an actions-speak-louder-than-words sense.

This whole run hotter thesis is already being tested at the Fed in my view with pulled forward taper and rate hike risk and multiple committee members agitating to start stepping back. Why? Because central bankers can't really forecast or exert great control over inflation and get spooked when they see it. As a case in point, the BoC has always had a symmetrical 1–3% band around its

2% mid-point goal and it has never really been able to run hotter in the upper half of its band while persistently averaging below 2% across all measures of inflation since the GFC.

Climate Policy

The main point here from a market standpoint is the expected abandonment of neutrality principles. The climate release said “the ECB will adjust the framework guiding the allocation of corporate bond purchases to incorporate climate change criteria, in line with its mandate. These will include the alignment of issuers with, at a minimum, EU legislation implementing the Paris agreement through climate change-related metrics or commitments of the issuers to such goals.”

I have to admit that it still bothers me deeply to see unelected central bankers picking winners and losers and distorting capital flows over time by basically imposing an additional carbon tax through monetary policy levers. It's a dangerous further step away from central bank neutrality. By dampening the cost of capital for targeted firms and industries, they'll create even more private reach for yield distortions in the debt instruments they are trying to thwart. Flooding the world with liquidity and negative yielding debt and now taking steps to target environmentally preferred credits could quash their returns even more and push private capital further into sectors less targeted by ECB purchases.

Housing Inflation

Also as expected, the ECB will begin taking into account owner-occupied housing in HICP inflation figures whereas to date Europe has not done so and by contrast to efforts in the US through owners' equivalent rent and in Canada through inclusion of new house prices as a driver of replacement cost within the shelter cost component of CPI. Point 3 in the strategy review summarizes the stance. Now if you include hot housing more explicitly in European inflation statistics and it adds to inflation, does that mean policy will be viewed as closer to target going forward?

FOMC Minutes

I didn't see any shiny flashy objects in yesterday afternoon's FOMC minutes ([here](#)) so saved a recap for this morning's note. The absence of any great revelations shifts the focus toward Chair Powell's testimony before the Senate next Thursday and his assessment of market developments may be more instructive than the minutes.

Tapering

Instead of “a number” of FOMC officials seeking to embrace a tapering dialogue over coming meetings, the minutes now say:

“Various participants mentioned that they expected the conditions for beginning to reduce the pace of asset purchases to be met somewhat earlier than they had anticipated at previous meetings in light of incoming data.”

“Various” is probably greater in greater than “a number” but “somewhat earlier than they had anticipated at previous meetings” is vaguer than “coming meetings” but a little further on the minutes returned to this guidance by saying:

“In coming meetings, participants agreed to continue assessing the economy's progress toward the Committee's goals and to begin to discuss their plans for adjusting the path and composition of asset purchases. In addition, participants reiterated their intention to provide notice well in advance of an announcement to reduce the pace of purchases.”

Still, the committee is not indicating a big rush while maintaining its focus upon incoming data:

“Many participants remarked, however, that the economy was still far from achieving the Committee's broad-based and inclusive maximum employment goal, and some participants indicated that recent job gains, while strong, were weaker than they had expected. A number of participants noted that the labor market recovery continued to be uneven across demographic and income groups and across sectors.”

Purchase Composition

On tilting the composition of future MBS vs Treasury purchases, the minutes were ambiguous.

"Several participants saw benefits to reducing the pace of these purchases more quickly or earlier than Treasury purchases in light of valuation pressures in housing markets. Several other participants, however, commented that reducing the pace of Treasury and MBS purchases commensurately was preferable because this approach would be well aligned with the Committee's previous communications or because purchases of Treasury securities and MBS both provide accommodation through their influence on broader financial conditions."

Inflation

On inflation, it's still "generally" the expectation that transitory factors are boosting inflation but there is a debate around that and the committee fundamentally altered its stance on risks to their inflation projections by saying:

"a substantial majority of participants judged that the risks to their inflation projections were tilted to the upside because of concerns that supply disruptions and labor shortages might linger for longer and might have larger or more persistent effects on prices and wages than they currently assumed."

Recall that the median projection offered at the June meeting was for a sustained overshoot on headline and core PCE over 2021–23 and so a "substantial majority" thinks it could overshoot by more than they are projecting.

The greater uncertainty around inflation forecasts was also reflected in the following two passages:

"participants generally expected inflation to ease as the effect of these transitory factors dissipated, but several participants remarked that they anticipated that supply chain limitations and input shortages would put upward pressure on prices into next year. Several participants noted that, during the early months of the reopening, uncertainty remained too high to accurately assess how long inflation pressures will be sustained. "

"Several participants expressed concern that longer-term inflation expectations might rise to inappropriate levels if elevated inflation readings persisted. Several other participants cautioned that downside risks to inflation remained because temporary price pressures might unwind faster than currently anticipated and because the forces that held down inflation and inflation expectations during the previous economic expansion had not gone away or might reinforce the effect of the unwinding of temporary price pressures."

The minutes included no reference to the debt ceiling/limit distortions in markets with much of the effect unfolding subsequent to the meeting. I continue to expect more emphasis upon the matter in Fed communications going forward and it's possible that Powell's testimony next week will broach the topic.

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