Rabobank: If The US Is Going To Win This War, It Needs Higher Rates, A Stronger Dollar, And Lower Commodity Prices

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WEDNESDAY, MAY 18, 2022 - 06:05 PM

By Michael Every of Rabobank

Everything Old is New Again

Using the matrix of both bond yields AND commodity prices I suggested yesterday as a judge of what the market is thinking vs. what the Fed then needs to be doing seems to have held water. Amid the usual "why bother paying attention to facts when one can buy dips" equity action, US 10-year yields surged 8bp back to 2.99% and 2-year yields 12bps to 2.69%, AND oil and wheat moved higher, the former to over $115 before dipping back to around $113, the latter starting lower but closing at a new record high. **Bonds sold off after we got a hawkish Powell interview that showed he was looking at the continued rise in commodities, not any falls in demand.**

Specifically, Powell stated "*There's an overwhelming need to get inflation under control*"; that "*this is not a time for tremendously nuanced readings of inflation: we need to bring it down in a convincing way. We do not see that right now. Some signs are promising, others are not*"; and that the Fed "*will push ahead with rate increases until we get as far as we need to get – we'll keep going.*" **Indeed, Powell stressed, "*Neutral is not necessarily a stopping point. If we have to go beyond neutral, we will not hesitate*."** He also underlined "*We will tighten until we are at a place where financial conditions are appropriate, and inflation is coming down*." In other words, **bond yields cannot truly come down before key commodities do**. Whocouldanooed?

For those rightly thinking that rate hikes don't help inflation driven by the supply side, which is seeing real incomes fall sharply for those outside Wall Street, there was no succour. Powell added the Ukraine war could last longer than expected, as could Chinese lockdowns, and that "*there is a real possibility that globalisation does into reverse to some extent.*" Indeed, while inflation is partly driven by supply bottlenecks, the Fed is not seeing much evidence of it "*healing,*" and, crucially, "*is not setting policy based on the view we get relief from the supply side.*" As such, "*we clearly have a job to do on the demand side*."

But what of the Fed's 2020 shift to focus on the lowest possible unemployment rate for all Americans in order to bridge socio-economic chasms? Well, now Powell sees the natural rate of unemployment as likely higher than 3.6%, where it sits, and implied he expects joblessness to rise ahead, adding he wants to see only "*healthy*" nominal wage inflation consistent with 2% CPI, which it currently exceeding in many places. (Australia just saw a 2.4% y-o-y print for Q1, which was below consensus, and may take some heat out of Aussie markets.)

Overall, Powell said there would be "*pain involved*" in doing what was necessary, and a "*soft-ish*" landing was only now "*plausible*". So, yes, the implication is the recession Mr Market is talking of – just not the rates easing-of-financial-conditions Fed response he was already starting to price for.

That was followed up by Evans arguing the Fed should raise rates to a 2.25%-2.5% neutral range "*expeditiously*", and favours "*front-Loaded*" hikes to transition to a more measured pace, which would give them time to monitor supply chains --which are being noticed and have no resolution-- in order to evaluate tighter policy.

In short, everything old is new again: hawkishness; **wanting higher unemployment and lower nominal (and real) wage growth; and a Fed that is prepared to talk the talk – although walking the walk, or walking and chewing gum at the same time, is yet to be seen**.

Meanwhile, we got more central bank news from Europe, where Reuters says, '[Exclusive-ECB's Lagarde gives national central bank chiefs louder voice on policy]'. The details are that ECB President Lagarde "*has given national central bank chiefs a bigger say in policy meetings, asking her own board to speak less and set aside more time for debate*," according to sources. Chief economist Lane and fellow board member Schnabel have been told to limit their presentations and leave more space for the central banks of the euro's 19 countries to air their views. This is implied as being introduced because "*a few voices typically dominate*," and "*criticism has grown since last summer as Lane and his staff repeatedly underestimated the size and duration of inflationary pressures. The surge in prices, which some ECB policymakers warned were persistent, eventually prompted the central bank to change tack and open the door to higher interest rates*." So, this is not so much about democracy as the fact that the loudest voices on inflation have been completely wrong (by not seeing everything everywhere all at once, as noted yesterday).

Regardless, it takes us back to an older era when a wider variety of speakers had a say. On which, wouldn't it be nice if we also got business, trade/logistics, and union voices heard around the central bank table too today, rather than just the financial sector and academic economists like Lane? Their input would certainly be relevant, it appears.

And why not national security figures too? The first modern central bank, the BOE, was set up to finance a major war, as were its European counterparts. (As the EU and UK are daggers drawn again over Northern Ireland, with trade war in the wind.) Today they cannot even do a good job of fighting inflation, let alone defending Western interests. Yet everything old may be new again there too due to the Ukraine metacrisis.

US Treasury Secretary Yellen is now talking of a new Marshall Plan, which takes us back to the 1950s. Inconveniently, that involves *winning the war first*, which means US Lease-Lease, which is already in place, taking us back to the 1940s, and integrating military, economic, and financial components: after all, the measurement of 'GDP' originated in the US in WW2 as a tool to win it, not to set up the quarterly 'guess the weight of the cake and make billions' competition it has since become.

If the US is going to win this war, it needs to address the economic component – which implies higher rates, a stronger dollar, and lower commodity prices to tame its inflation and reduce Russian income. Others might want similar FX movement, as the EIA notes today: "*A strong US dollar means that countries that use currencies other than the US dollar pay more as crude oil prices increase. Since June 1, 2021, the Brent crude oil price has increased by 59% in US dollars and by 86% in euros."* Now imagine your currency collapses because you try to do 'new normal' QE while running commodity-driven trade deficits - and you don't get Fed swap lines,… as Turkey's TRY stumbles further over geopolitics, and China stops reporting foreign investor bond trades as capital outflows accelerate, and new home prices just dropped 0.3% m-o-m.

Yet the US will also need to address the financial component. Being *very* charitable, that might explain why there are rumors flying around that the White House is considering de facto *forcing* Russia to default on its foreign debt by not extending a soon-to-lapse rule allowing Moscow to make such dollar payments. It will also involve joined-up actions such as **offering India $500m in US military aid**, approaching the levels offered to Egypt and Israel, to persuade it to switch from Russian to US weapons, as part of a broader geopolitical realignment. (Which was already underway via The Quad: this is also to help tip the balance as India decides between French and US planes.)

Yet at the same time, this links back to supply chains. There are reports that Ukraine has already depleted a quarter and a third of the total US stock of Javelin and Stinger missiles, and current US production is in no way capable of replacing them: they are being fired far faster than they can roll off of production lines. Imagine what happens if the war drags on beyond the end of the year. Imagine if a new war begins somewhere else. Imagine the global military hegemon without the weaponry it needs to fight. And that dilemma brings us back to integrating military, economic, and financial components.

Relatedly, we recently got another 'old is new' shift from the IMF, who are now officially more supportive of capital controls, pre-emptively in some cases. Those who follow a Godley approach to balance sheets would point out that there are many good reasons for introducing capital controls like the ones we had under Bretton Woods, which takes us back to 1945-1971. If you don't have destabilizing global capital flows, you don't have destabilizing global trade deficits, *because the former drives the latter.*

Meanwhile, those who follow a geopolitical-realist approach to markets will extend the argument to say **it is the US which is most likely to ultimately introduce capital controls (and more tariffs) against some countries which it runs large bilateral trade deficits with,** i.e., no US capital outflows *to* China, and no capital inflows to the US *from* China, which would effectively decouple the two. And when one says 'ultimately', one is not looking too far into the future at the rate things are shifting and given the train of thought from the US Trade Representative. One is not only looking at China in this regard. Germany could be in the cross-hairs too if the country fails to follow through on its promise to rearm before the 2024 US presidential election, and instead goes for more appeasing '*trundle durch bumble*'.

Imagine the rates impact of this kind of US policy shift towards trade only within an Anglosphere, or a Network of Liberty, or 'Freedom Trade' not free trade. Yet is not out of the question based on the current political and geopolitical trends and the iron logic of war. Far from it. Rather, everything old is new again.

"Don't throw the past away; You might need it some rainy day; Dreams can come true again; When everything old is new again

Get out your white suit, your tap shoes and tails; Put it on backwards when forward fails; Better leave Greta Garbo alone; Be a movie star on your own"

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