Morning Comment

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AFS Insights

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Headline Sweep

- Zelenskyy warns of ‘ugly’ Russian attack before Independence Day
- ECB’s Nagel Wants More Hikes, Says German Recession Likely

Overnight/Day Ahead/Week Ahead Comment

- **Meanwhile in markets, US Treasury yields are hovering around Friday’s highs ahead of the all-important speech by Fed Chair Powell at Jackson Hole later this week**. Clearly, markets expect a relatively hawkish performance by Powell. A case in point is recent Fed-speak: regional Fed Bank Presidents have walked back Powell’s July FOMC press conference pivot. Recall that Powell basically shot down the Fed’s rate hike plans for 2023. Clearly, with just one better than expected CPI report paling in comparison with all those inflation misses month after month, Fed-speakers rather err on the side of tightening more.
- **At pixel time the US 10y was a few bps below the magical number of 3 percent, while the 2-year traded at 3.26**. The recent increase in bond yields was driven by higher real yields, especially for shorter tenors. Believe it or not, but US 2-year real yields are now positive too (longer maturities were already positive). Furthermore, the US ex ante real short rate should turn positive after the next Fed rate hike:

Note that the real short rate is defined as the (central bank) overnight rate minus the 1-year inflation-linked swap rate). Clearly, punters are betting the farm on the Fed taming inflation.

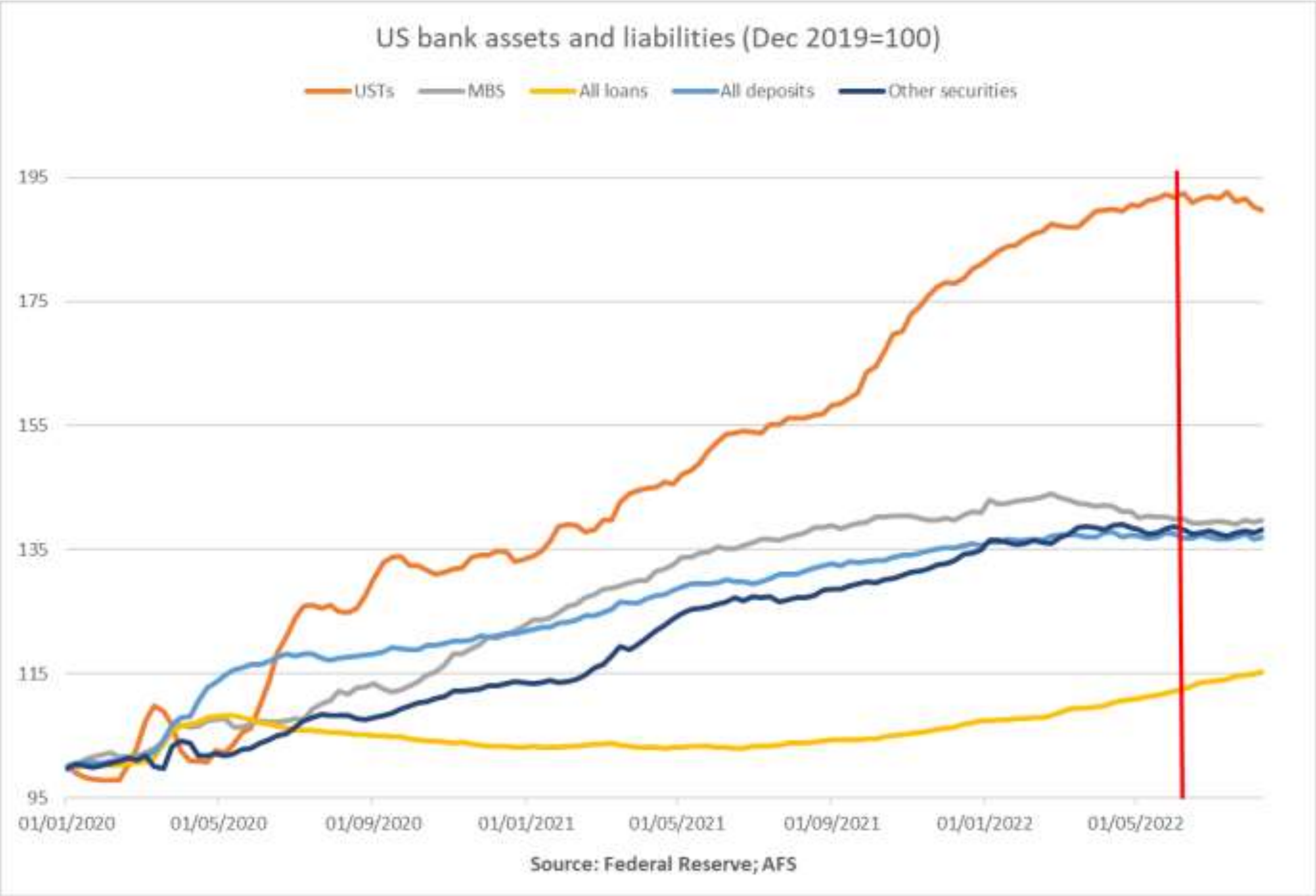
- **As the real short rate chart shows, the situation in the Eurozone is distinctly different than in the US**. Market-based measures of inflation compensation are higher here than in the US, which is weighing on Eurozone real yields. The ongoing energy crisis can easily explain higher inflation expectations in the Euro area. That energy crisis is the work of one man named Vladimir Putin, by the way. But we digress. In any case, in the eyes of the market, the ECB's task of controlling is more daunting compared to the Fed. The only saving grace as far the inflation situation in the Eurozone is concerned, is that we expect the Eurozone to enter a recession some time before the US does. Recessions tend to be disinflationary.
- **With markets more worried about relatively higher Eurozone inflation, ESTR OIS have had a change of heart and priced in rate hikes for 2023 once again (50bps in total).**
- **Resuming with some market commentary, Asian equities are mostly lower this morning despite what appears to be another piecemeal attempt by Beijing to tackle the ongoing property market crisis**. S&P 500 futures are about 20 points below Friday's close. Hawkish Fed pricing ahead of Jackson Hole has reinvigorated the dollar rally. Against the majors the dollar is close to what is possibly an all-time high. EM currencies, as measured by the JPM currency basket versus the dollar, are a half percent above their all-time low. Commodities are flattish at the start of the week. Remember that commodities have mostly tracked the rebound in equity prices in August.
- **Looking ahead, we a have an empty calendar for today**. Tomorrow's calendar is packed full of data, including the Markit PMIs. Eurozone PMIs are expected to drop marginally and a bit further in contraction territory in August. Expect the undertones of the PMIs to flag a recession later this year.
- **Jackson Hole starts on Thursday, though Powell's speech is scheduled for Friday afternoon.** Besides Powell's guidance on rates, also keep an eye on his remarks on Quantitative Tightening (QT). QT will rev up to full speed next month, with USD95 billion of USTs and MBS rolling off the Fed's balance sheet every month. By the end of the year, the Fed's balance sheet should have decreased by close to USD600 billion. To put the QT numbers in perspective, a USD95 billion monthly run rate will mostly offset bank money creation. Here's why.
- **We start with a simple question**. How do banks create money? By buying securities or granting loans:

US Banking System

Loans Private sector securities Government Securities	Deposits (money supply)

- **Money supply, or M1 in its most narrow form, is a well-known and easy to understand concept.** It's simply the sum of currency in circulation, bank deposits plus a product that is specific to the US, namely money market deposit accounts. When banks buy securities or grant loans, they create money – deposits in this case.[1] So, we have deposits and the counterpart on the asset side of banks' balance sheet: loans and securities. Let us call them bank credit.

- **Bank credit has increased by roughly USD100 billion in the past four weeks compared to the prior four week period.** The four-week moving average increase in bank credit is USD115 billion since the start of QT at the beginning of June. When QT runs at full steam from, bank credit growth is mostly offset. Put differently, the deposits that banks create with granting loans and buying securities will be offset by the private sector buying the Treasuries that roll off the Fed's balance sheet. The private sector includes banks, of course. Banks can use reserves (an asset on banks' balance sheet) to buy Treasuries. That means no money (i.e. deposits) is destroyed when the nonbank private sector buys Treasuries. However, banks appear to have no appetite for Treasuries.
- **The table below shows bank securities' holdings and loans on an index scale.** Each series is on a separate scale with the first week of January 2020 as the starting point. The data is compiled and released by the Fed on a weekly basis and with a two-week lag. Note that the vertical red line denotes the start of QT in the first week of June:



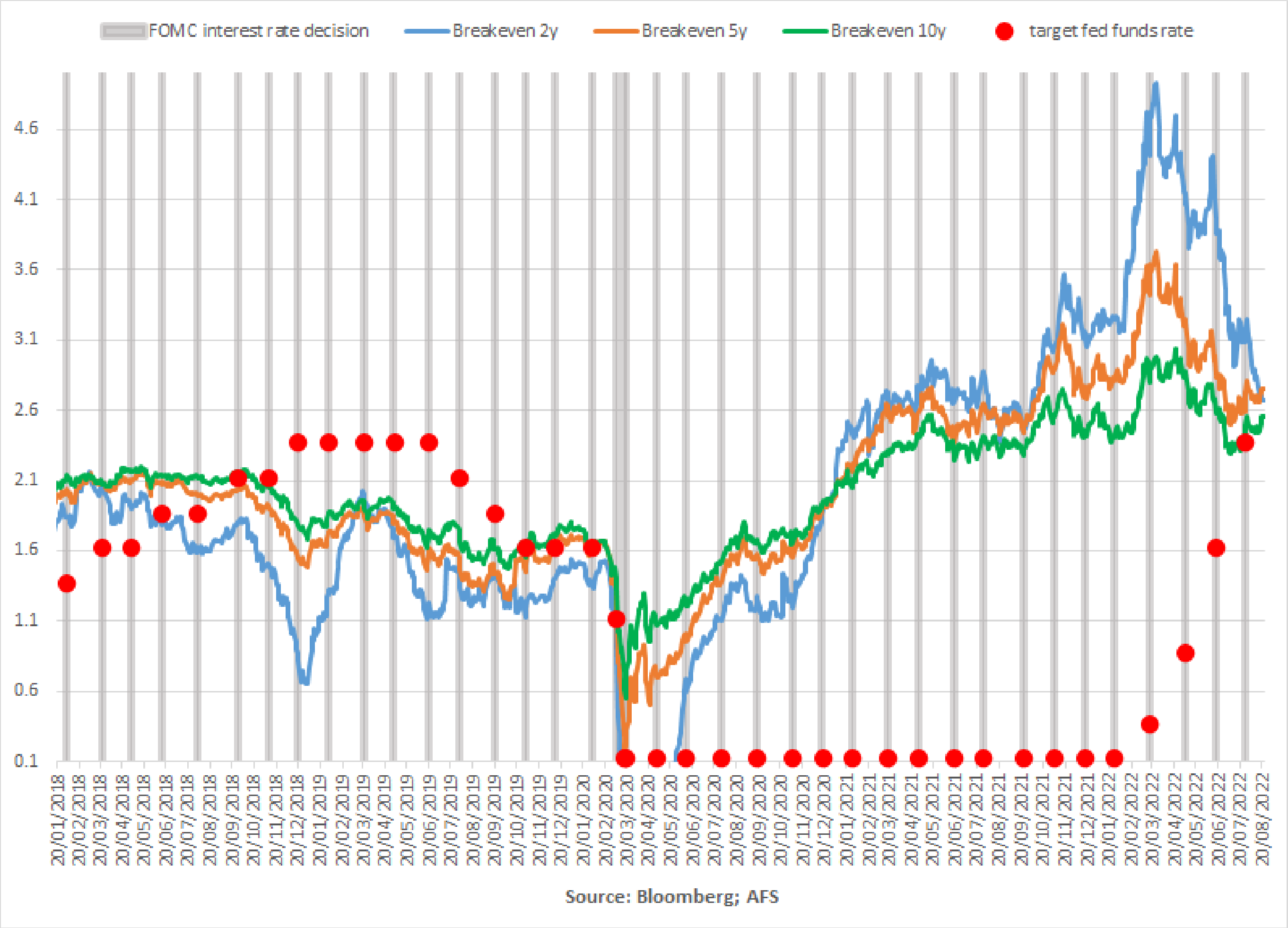
- **In June banks' Treasury holdings were flat.** In July they started to fall. Other securities holdings have been flat since the start of QT.[2] Only loans, the biggest

[1] There are a few more steps involved when banks buy Treasuries, but that's irrelevant here.
[2] Deposits have also been flat since the early spring. However, we believe the deposit data is flawed, and that the money supply is understated as we explained in the July 13 Comment. We will come back on the matter in a separate Comment.

asset on banks' balance sheets, are still increasing. In any case, if banks aren't buying the securities that are rolling off the Fed's balance sheet, the nonbank private sector is, using deposits. And if deposits are no longer growing, the consequences for nominal GDP growth can be pretty significant. Remember Fisher's equation of exchange that states that nominal GDP equals the money supply times velocity. If the money supply – basically (bank) deposits – is flat, then nominal GDP growth becomes a function of increases in money velocity. Which is where it starts to get difficult, especially for the Fed.

- **The bottom line for now is that the Fed will likely be successful in neutralizing one source of inflation: bank credit and money creation.** Money velocity is an entirely different kettle of fish though. There is a historical precedent here, fortunately. When Paul Volcker, the Fed's most famous post-war Chairman, fought inflation in the early 1980s, that inflation was more the result of rampant velocity than it was money growth. We all know very well how Volcker tamed inflation: by raising short term rates to truly punitive levels. The ensuing recession was accompanied by a collapse in velocity. Since the Volcker shock, every recession coincided with a collapse in money velocity:

- **Unless Powell & Co lose their nerve, monetary policy will be sufficiently tight to produce another recession.** The velocity of money will then collapse, taking inflation with it. If one takes US inflation-linked swap rates and breakeven rates at face value, the recession will do the job and kill inflation:



Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
10:00		SNB Domestic Sight Deposits CHF	Aug-19	--	644.1b
10:00		SNB Total Sight Deposits CHF	Aug-19	--	751.3b
11:00	Cyprus	Sells 91-day Bills			
11:30	Germany	Sells EUR3 Bln 2023 Bills (DE0001030872)			
12:00	Belgium	Sells 0% 2027; 0.35% 2032 Bonds			
14:30	US	Chicago Fed National Activity Index	Jul	--	-0.19
14:50	France	Sells Up to EU1.6 Billion of 350-day Bills			
14:50	France	Sells Up to EU2.8 Billion of 91-day Bills			
14:50	France	Sells Up to EU1.4 Billion of 140-day Bills			

Consensus data: Bloomberg News; All Times Are in Central European Time

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