Weekly Market Summary

5th of June 2015

10-Year German Bund Yields Fail To Break 1% on Upside! Bond Armageddon Delayed for Now?! - Fadi Nasser *(SVP – Head of Treasury Sales)*

Markets breathed a sigh of relief yesterday afternoon as German bund prices bounced back with a vengeance after 10-yields tested and rejected the psychological 1.0% level (intraday high of 99.6 bps, not showing in the below daily closings chart) . The contract bounced hard following a 6 points sell-off from Tuesday's high (a 55 bps jump in yields in less than 72 hours!).

10-Year German Bund Yields

So what really caused this latest bond rout and resulted in German government bonds posting their worst week in the Euro history?

It all started in early April, when DoubleLine Capital's Jeffrey Gundlach said he was considering making an amplified bet against German debt, whilst predicting that German bund yields were extremely depressed and would soon adjust higher. Those statements, coupled with Janus Capital's Bill Gross calling bunds the "*short of a lifetime*," contributed to a selloff in German debt that saw 10-year yields increase from as low as 0.049% in April to a high of 0.805% in mid-May (roughly 1600% increase we had referred to in recent write-ups). Following that, markets stayed confined in a narrow range. And then Super Mario spoke!!

Following a stronger inflation report (Eurozone May CPI +0.3% YoY, core CPI +0.9% YoY) last Tuesday - confirming that earlier fears of European deflation were overblown and causing a minor bond market sell-off - ECB President Mario Draghi added fuel to the fire by stating that markets must "*get used*" to periods of higher volatility thanks to very low interest rates that can exacerbate price swings on the debt. In a press conference on Wednesday afternoon - following the Bank's decision to keep Euro interest rates unchanged - Draghi also predicted Eurozone inflation would start picking up later this year.

As German government bonds crashed, yields on U.S. 10-year Treasuries followed suit, rising close to 30 basis points to their highest level since October 2014 (peak 2.40%, last 2.35%). With the rout spreading, traders cancelled meetings and rushed back to their desks to deal with the price swings/severe MtM changes. Whilst bonds are a bedrock of global financial markets and are usually perceived as long term safe investments, this week's sell-off has wiped out all of 2015's gains on the Bank of America Merrill Lynch Global Broad Market Index of bonds (includes bonds with a total face value of $41 trillion), which had been up 2.3% as recently as April.

Elsewhere, markets learned yesterday evening that Greece has submitted a request to the International Monetary Fund (IMF) to bundle its four payments due in June into one lump-sum payment later this month, amid a standoff with its creditors over the terms attached to its bailout. "*The Greek authorities have informed the Fund today that they plan to bundle the country's four June payments into one, which is now due on June 30"*, IMF spokesman Gerry Rice said in an e-mailed statement. "*Under an Executive Board decision adopted in the late 1970s, country members can ask to bundle together multiple principal payments falling due in a calendar month*". A Greek official with knowledge of the matter said the appeal was submitted by the Bank of Greece, at the request of the government.

Greece has last rejected the latest proposal from its international creditors, with the Finance Ministry saying the plan "*can't solve the riddle*" and an agreement requires "*immediate convergence of the institutions to more realistic proposals*". While international officials have reported some progress in recent days, German Chancellor Angela Merkel said "*we are still far from reaching a conclusion*." The country has about 1.5 billion euros (US$1.7 billion) it needs to pay the IMF this month, and the first tranche of about 300 million euros was due today. The latest decision underscores the state of the country's shriveling finances. "*The delay in the payment to the IMF is an escalation of the confrontation*," Nicholas Economides, an economics professor at New York University's Stern School of Business. "*It increases the risk of bankruptcy and Grexit*". The euro fell 0.3% against the dollar to US$1.1240, after trading to a high of rising to $1.1380 earlier in the day.

This afternoon, traders' attention moves quickly to two highly awaited announcements that will surely having a marked impact on future market trends:

1- **US Non-Farm Payroll Release:** The US Bureau of Labor and Statistics (BLS) is scheduled to release the May job data later in the day. Market participants are looking for a solid 225,000 new jobs creation for last month (following a strong 223,000 showing for the month of April), whilst all remaining components are expected to stay little changed (unemployment rate at 5.4%, average hourly earnings at +0.2% MoM / +2.2% YoY, average workweek at 34.5 hours and labor force participation rate at 62.8%). Given this morning's resumption of the sharp bond selloff in both Europe and the US, maybe – just maybe – the BLS would be better off releasing a not-too-hot job report, somewhere in the neighborhood of 195,000/5.5!

   Actual Outcome: US Job gains were very solid in May, with payrolls growth of 280,000 - well above the 225K consensus - along with upward revisions totaling 32K for the past two months. The unemployment rate edged back up a tick to 5.5%, but that was solely due to a slight increase in labor force participation and the change in employment on the household survey almost matched that seen in payrolls. Hourly earnings were a little stronger than expected, coming in at 0.3% on the month and 2.3% year-over-year.

2- **OPEC Decision on Future Oil Production:** OPEC ministers – meeting in Vienna - are expected to maintain the Organization's output target (announcement expected for later this afternoon, 5:00 pm Bahrain time), whilst Iran has signaled it wants a greater share of the cartel's production. Iranian oil sales have been crimped by sanctions imposed over its nuclear program, but those could be eased by June 30th if Tehran reaches a nuclear deal with six world powers. Petroleum Minister Bijan Namdar Zangeneh said his country was eager to sell more crude and added that Iranian production does not have to be approved by the Organization of the Petroleum Exporting Countries because "*it's our right to return to the market*." OPEC is already producing more than its target of 30 million barrels a day even without the additional 1 million barrels a day Tehran hopes to produce within a year. Oil prices had already dropped in past days on speculation OPEC will maintain or even slightly increase its production target, leaving the market oversupplied. Futures dropped as much as 1.1% in London this morning, extending the week's decline to 6% (WTI last at $57.65, Brent at $61.80). Oil production is a sovereign right and shale isn't a threat to the industry, Saudi Arabia Oil Minister Ali al-Naimi said in Vienna. His Kuwaiti counterpart said there may be a proposal for the group to raise its production limit.

Actual Outcome: The Organization of the Petroleum Exporting Countries (OPEC) agreed to keep the oil pumping, with no change in its production quotas, at today's group meeting. Even though oil prices are about 40% lower than a year ago, OPEC decided to keep its output target at 30 million barrels a day in an effort to maintain market share and respond to robust production in the United States, but left it to members to restrain their overproduction. The meeting was the first since Saudi Arabia urged the OPEC cartel late last year to give up a decades-long policy of trying to manage prices through adjusting supplies of oil.

Last but not least – in case you have missed it! - The International Monetary Fund (IMF) joined the debate over when the Federal Reserve should start raising interest rates, calling on the central bank to wait until the first half of 2016 and cutting its U.S. growth forecast for the second time this year. The lender also said that the dollar was "*moderately overvalued*" and a further marked appreciation would be "*harmful*," in a statement released Thursday in Washington on its annual checkup of the U.S. economy. Coming to her dearest friend (Janet Yellen) rescue, the IMF's Managing Director Christine Lagarde added that "*we still believe that the underpinnings for continued expansion are in place, though the inflation rate is not progressing at a rate that would warrant, without risk, a rate hike in the next few months*". That means the Fed should wait until early 2016, even if there's a risk of "*slight over-inflation*" relative to the central bank's 2% target, Lagarde said. The lender's call for caution comes as two Fed governors, Daniel Tarullo and Lael Brainard, cast doubt on the strength of the U.S. recovery from a first-quarter contraction. Both officials questioned whether the slump could be written off as the result of temporary effects including harsh winter weather and closures at ports, or whether markets were witnessing "lost momentum in the underlying performance in the economy".

Unfortunately, day after day we see compelling parallels with the central bank policy backdrop of a decade ago, when cheap money stoked the risk-taking that caused the crisis. And this time around - with excessive money and speculation building up for more than six years and a Fed reluctant to take any immediate monetary policy action aimed at less liquidity accommodation - we strongly feel the conclusion of the low rates environment will most likely end again badly!

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