Weekly Market Summary

10th of June 2016

A Clueless Federal Reserve ….. Record Low Yields …. And Undecided UK Voters !!
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Two weeks ago, I wrote about bond traders getting it wrong all over again and suggested that investors' reach for yields - by extending maturities, moving down on the credit curve or some combination of the two - would soon backfire given renewed easing in global financial conditions, a stabilizing China, an improving US economy and recent hawkish Fed speak. I also sincerely believed it would be wise to warn our valuable clients that sooner or later economists and the Fed will be right again, the case for more aggressive interest rate hikes would become clearer to all, and when that happens the resulting abrupt sentiment turn in the market will surely translate into a violent bond reversal and much higher yields! Needless to point out how premature or "possibly" inaccurate such assessment would turn out to be!!
The real turnaround in markets – though towards lower yields - began some 10 days back, when various UK polls on EU started showing a lead for the Leave Camp (rising uncertainties, in turn translating into risk-off sentiment). That was followed by a disastrous US Non-farm payroll report on June 3rd, a benign 38,000 increase in jobs for May versus market expectation for a 160,000 increase! (Funny that we are always reminded that one month data doesn't make a trend when payroll or inflation data print on the strong side!). As a result, US rate hike expectations suffered a considerable blow, with markets now fully discounting a Fed on hold at the upcoming June 15th FOMC meeting, and a small 16% probability for a July 27th rate hike (surely my view on that outcome does not matter any longer! L).

Federal Reserve Chairman Janet Yellen - speaking at the World Affairs Council of Philadelphia on June 6th - called the weak jobs data "*concerning*", but was quick to stress her optimism in the path of the US recovery, citing previous large employment gains, wage growth and the relatively low number of Americans filing new claims for unemployment insurance. Yellen added that the current level of short term interest rates - just above zero - is "*generally appropriate*," but that she expects the Fed to raise rates in the future "*provided that labor market conditions strengthen further and inflation continues to make progress toward our 2 percent objective*." This dousing of an imminent shift higher in US borrowing costs (effectively that is how markets interpreted Yellen's remarks) prompted investors to buy equities, corporate debts and commodities. As Wall Street took a shot at setting a new record high for the S&P 500 and oil's momentum sought traction beyond $50 a barrel, 10-year US Treasury yields also slipped and closed below 1.70%, a floor that prevailed in the wake of market stress peaking back in February (back then though, stocks were down in excess of 10% from current levels, China was in turmoil and oil had just hit a fresh low!).

How much longer can the Fed tolerate that the market completely ignores its signals is the question that should be on everyone's mind? Admittedly, the Fed's - as well as other central banks' - behavior and about-face guidance over the past few years is a major cause for this credibility crisis. Nonetheless, that surely does not mean that it now has to accept the current situation. Whereas over the past years Chair Yellen used every totally irrelevant data publication as an argument against rate hikes, she - and her colleagues - are now very open on improving US economic trends and the need for gradual rate hikes going forward! Only this time around, the market does not want to believe it (that possibly explains why Guru Bill Gross warned yesterday that the current $10 trillion of negative yielding bonds is a *'supernova that will explode one day'!*).

Moving to the UK, and with less than two weeks to go until the EU Referendum, the polls have narrowed from last month with 'Remain' and 'Leave' camps both neck and neck (in fact the "Leave" camp has the lead now in the latest polls). Economists and strategists agree that a 'Leave' vote would trigger a major risk off event, possibly including a UK recession, a 10-15% drop in the value of the British Pound, a 5-10% drop in global equity markets and Bank Of England (BOE) rate cuts (whilst a major risk-on rally would set in place should the "Remain" vote prevail).

With that message well-advertised, one remains puzzled that just a quarter of voters believe that Britain leaving the European Union would make them poorer, according to new polling that suggests the remain campaign's central message is failing to hit home. Britain Stronger in Europe has poured resources into convincing the public that a vote to leave on June 23rd would jeopardize economic growth and hit jobs, and the UK Treasury published research suggesting it would cost the average household £4,300. And while 63% of those polled by Ipsos Mori thought leaving the EU would reduce immigration – the central thrust of the leave campaign – just 25% think it would reduce their own living standards! The poll also suggests that with a fortnight to go before the vote, the remain camp's key proposition – that leaving the EU would "*put a bomb under the economy*", as David Cameron called it – has either not reached the public, or is not believed. More than a tenth of voters – 13% – said they believed they would be better off after a Brexit; the remainder said it would make no difference, or they didn't know. The same survey also revealed a series of public misperceptions about the EU and what it means for daily life: Those surveyed believe 15% of the population (10.5 million people) is made up of EU migrants, compared to 5% (3.5 million people) in reality. Voters also tended to overestimate the UK's financial contribution to the EU, the research found, with nearly a quarter (23%) saying the UK is the single top contributor, while in reality, it is fourth, behind Germany, France and Italy. Clearly, now is the time the UK public gets provided with as much factual information about the EU as possible before they cast their final vote!

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