Weekly Market Summary

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Bond Traders Getting It Wrong All Over Again!! Time for a Sizable Market Shakeout ?!

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Bond markets have rarely been that much overpriced, and the 2016 YTD bond market outperformance looks like the early part of 2013 all over again! One simply needs to consider the large size of indirect bidders (global central banks, fund managers) piling into Wednesday's UST 10-year auction – with the benchmark note sold at the lowest yield in more than three years (1.70%!) – to realize how complacent bond traders have become! Also, volatility in the U.S. bond market has been consistently falling along with the odds of a Fed move. The Bank of America Merrill Lynch MOVE Index - which measures price swings in U.S. debt – closed yesterday at 63.92, the lowest level since the end of 2014, before this afternoon's release of crucial economic data (Retail Sales, Producer Prices and Consumer Sentiment).

Around the world, bond traders are picking up almost anything with a yield, and this week's strong auctions – not just in the US, but also in Japan, Spain and Portugal - are a clear indication of unprecedented investor appetite. The driving force behind this growing bond "bubble" – where investors reach for yield by extending maturities, moving down on the credit curve or some combination of the two - is the rising universe of negative-yielding securities, which has extended beyond US$ 9 trillion since the European Central Bank and Bank of Japan cut interest rates below zero. "*There is clearly a lot of demand any time you can get something with positive yield*," said Kathy Jones, chief fixed-income strategist at Charles Schwab & Co. in New York. "*If you are a buy-and-hold investor, you might as well -- every chance you get*." JPMorgan Chase & Co. predicts that, with the supply of debt falling, conditions in the global bond market will be so favorable in 2016 that record-low yields are probably in store.

And whilst governments/companies' officials celebrate such great times (Portugal successfully issued 10 year securities, Spain sold 50-year bonds and Japan had no problem printing 30-year paper!) - where bond issuances turn into smooth and profitable decisions – buyers/investors continue to steer into riskier investments that are now increasingly vulnerable to corporate defaults or rising interest rates. For the latter, that is because debt with higher duration, such as obligations with longer maturities, suffers steeper losses when interest rates rise.

Once again, bond traders are betting the Federal Open Market Committee (FOMC) is being too optimistic about the US economy and that interest rates will remain low well into this decade (likelihood of a fast removal of monetary policy accommodation is very small!) . Traders are essentially counting out another Fed interest-rate increase for the time being – with futures not fully reflecting the next hike until mid-2017, according to data compiled by Bloomberg (50% odds for one 25 bps rate hike are still priced for this year) . In the very near-term, rightly or wrongly, no one is really afraid of the Fed (or Grandma Yellen!). However, as the unemployment rate declines and inflation picks up in the coming months, the danger for the bond market is that the FOMC's current projection of the dots may be too low.

Rather than a funds rate of 0.875% by the end of 2016 and 1.875% by end-2017 (the latest Fed “dot plot”), it could well be surpassing those forecasts and surely exceeding the slower ascent suggested by the interest rate futures market (the “dot disbelief”).

Then again, one can hardly blame bond investors for betting against the predictive power of the FOMC. Over the past few years, investors have made a lot of money assuming that Fed policy outcomes would ultimately be more accommodative than mainstream FOMC rhetoric implied at the time. Hence the current comfort level seen in the bond market, with recent steady low yields and suppressed volatility. Also for now, central bankers seems to be unwilling to push intermediate and long-term rates up prematurely – with the market turmoil at the beginning of the year leaving deep scars on the Fed Committee and the upcoming June 23rd Brexit referendum keeping all market participants edgy - but they also surely want to avoid another violent re-pricing of market expectations when lift-off becomes again unavoidable, especially that the official view for an economy heading towards a sustainable recovery continues to prevail.

I have little doubt that many of our readers will simply ignore current warning signs, having already witnessed how wrong Fed officials and Wall Street economists have been on interest rates over the last few years (count me in too!). Sooner or later though, the “big idea or trade”, if there is such a thing, is that economists and the Fed will be right again and the case for more aggressive interest rate hikes will become clearer to all. At that point, the resulting abrupt sentiment turn in the market will translate into a violent bond reversal (higher rates)! And because yields are so low now, even mild disappointments will lead to big losses.

Don’t Say You Haven’t Been Warned!!

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