Weekly Market Summary

29th of July 2016

The Bond Bubble Keeps Growing.... Bond Vigilantes Nowhere In Sight!!
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The bond vigilantes are acting a lot less vigilant these days! There was a time, following the inflation crisis of the early 1980s, when the bond market, regardless of the Federal Reserve's policy, worked to keep a cap on bond prices (lower prices & higher yields) just to be sure the economy did not get too steamy. Whenever there were signs that the pace of growth was picking up, the so-called vigilantes would rush to sell, driving interest rates higher and acting as a brake on the economy.

But if this July is any indication – not to mention the price action over the past 6 months - a new era may be upon us! The bond market is soaring. The yield on the benchmark 30-year US bond has recently plummeted to a record low 2.08% from the 3.04% level witnessed at the beginning of the year (similarly 10-year US yields traded to a low of 1.32%, down from 2.25% at the start of 2016!). Behind it all is a conviction among bond investors and traders that the Federal Reserve would not risk raising interest rates too fast (nor too far) until global growth and inflation actually show signs of holding up and political/geopolitical tensions ease!! *(my take on this matter remains strongly one of "excessive central banks' manipulation translating into the mother of all financial bubble").*

Overall, of course, that is good news for bonds and bondholders! But it portends more volatility, and, somewhere down the road, perhaps some brutally painful losses. After all, recently released US data – including June figures for Non-Farm Payrolls, ISM Non-Manufacturing, Retail Sales and Consumer Price Inflation – has uniformly and largely surprised to the upside (in normal times that would have triggered a major bond sell-off/re-pricing!). Even last Wednesday's FOMC upbeat statement (The Federal Open market Committee "FOMC" decided to leave the US benchmark rate unchanged at its July 27th monetary policy meeting, but the economic assessment pointed to more confidence in the overall economic outlook, diminished concerns about the US labor market and subsiding near-term risks in the aftermath of the "Brexit" decision) - a very useful tool for conveying policy hints - did not prevent yields from moving/closing lower on the day.

But then again, just like the Boy Who Cried Wolf, the Fed has cried "hike" so often and failed to deliver and markets are rightly ignoring their message! The Fed could now opt to wait and see how the economic data plays out (most importantly the Q2 GDP release later this afternoon with market consensus for a +2.5% quarter-on-quarter annualized growth, July ISM Manufacturing out on August 1st, July ISM Services out on August 3rd and July payroll on August 5th). If the data is good, markets - on their own - should start pricing in a higher probability of a rate hike in September (next FOMC meeting scheduled for September 21st, and will be followed by a press conference).

Or it could decide that the market - once again - needs to take rate hikes more seriously, and initiate a media barrage to put a September hike firmly on the table *(Fed Chair Yellen and her colleagues would let out their frustration that the market did not respond - as they planned - to their decision making process and various commentaries, and the Fed could feel more pressured to boost interest rates, believing it is now on its own in the inflation battle and can no longer count on investors to send yields higher when the economy improves!).*

Elsewhere, the Japanese yen strengthened markedly this morning (trading down to 103.30 from 105.50 against the US Dollar) as the Bank of Japan kept its key monetary tools unchanged (policy interest rate untouched and JGBs monthly purchases unchanged), whilst promising to mount a comprehensive review of its policy framework due to "*considerable uncertainty*" about the outlook for inflation, which has consistently underperformed the central bank’s forecasts. However, Governor Haruhiko Kuroda and his team did enlarge a program of buying exchange traded funds (“ETFs”) by JPY 2.7 trillion (roughly U$26 billion) a year, in a move to shore up confidence in light of post-Brexit volatility in financial markets and a slowdown in emerging markets. A dollar-lending facility was also expanded (the Bank of Japan doubled its lending program to support growth in US dollars to US$ 24 billion to back the overseas activities of Japanese firms). BOJ’s Kuroda reiterated that further easing will be done if needed and said that Japan’s central bank has not hit a policy limit.

**2nd quarter US GDP was released later in the day and showed that the US economy expanded less than forecast 1.2% in the second quarter, after a weaker start to the year than previously estimated (0.8% versus 1.1% initially reported), as companies slimmed down inventories and remained wary of investing amid shaky global demand.*

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