Weekly Market Summary

20th of May 2016

This Week's Bond Market Sell-Off....An Early Rehearsal or the Real Thing?!
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In last week's economic piece entitled "*Bond Traders Getting It Wrong All Over Again! Time for a Sizable Market Shakeout*?", I stressed that traders' complacency with regards to bond yields remaining low had reached heightened levels and backed that view by referring to the large size of indirect bidders at recent US auctions (those being awarded at low levels not seen in more than 3 years!), as well as the depressed level of bond market volatility - at a time Federal Reserve officials were using their daily appearances on various news network to remind market players that 2-3 rate hikes for the remainder of 2016 continued to be their central tendency (versus markets counting out another Fed interest rate increase for the time being and interest rate futures not fully reflecting the next hike until mid-2017).

For "big pockets" contrarian traders, such environment would have - in normal times - presented the perfect opportunity to place large bets against the views of the larger trader community (effectively breaking from the herd and formulating one's own sensible opinion). Then again, contrarian traders had been burned in past years and their short bets against US Treasuries (and other G-7 government bonds, also trading at absurd levels) had resulted in large losses, especially that Fed policy outcomes had always turned more accommodative than then mainstream FOMC rhetoric implied at the time.

Still, such reasoning did not prevent us from gently reminding our valuable clients (with special consideration to those with large un-hedged floating term liabilities) that sooner or later 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!

So what exactly happened this week?? And should the recent bond selloff be seen as an early rehearsal or the start of the real thing??

It all started last Friday afternoon, when US data releases – covering Retail Sales, Michigan Consumer Confidence and Business Inventories - all printed well ahead of the decent increases forecast by economists, with large gains suggesting that increased wages/savings (as a result of strong employment and low oil prices) were finally flowing through to consumption. The USD immediately reacted, strengthening against its peers whilst fed funds pricing of Fed hikes barely moved (chances for a June Fed hike moved from 4% to 6%).

Then came the weekend warning from BlackRock – the world's biggest money manager! According to a late Friday note from its chief fixed-income strategist, Jeffrey Rosenberg, traders had "*gone too far*" in discounting the chances the Federal Reserve will raise rates this year. "*The market may be pricing in too slow a policy-tightening pace*", Rosenberg said. The odds derivatives traders assign another rate increase by the end of this year are little more than a coin flip versus more than 90% chance at the beginning of this year. Yet, global economic conditions appear more stable. "*There is very little cushion, in terms of market pricing*," if the Fed keeps hinting at raising rates more quickly than traders expect, Rosenberg added. "*There is a lot more downside right now than upside*"!

Turns out Rosenberg was right! Fed officials on Monday & Tuesday again talked up the chances of near-term rate rises: To all market pundits who assumed that the path to multiple rate increases would be limited by a few specific events (specifically U.K.'s June vote on remaining in the European Union on June 23rd , the November 8th U.S. election and Chinese Ballooning debt burden and stalling growth momentum) - and as a result only the Fed's July and December meetings would present realistic opportunities to act - Fed governors were out in force (Fed's Williams, Lacker, Lockhart, Kaplan), banging the drum for higher interest rates, stressing that at least two interest-rate increases may be warranted this year based on the recent improvement in economic data (especially rising inflation), with the first hike needed in the not-too-distant future (Federal Reserve Bank of Dallas President Robert Kaplan – previously 23 years at <you guessed it right!> Goldman Sachs).

The Wednesday market shift from "Why the Fed won't risk a rate hike next month" to "Fed is seriously considering raising interest rates in June"!!

On May 18th evening, released minutes for the Federal Open Market Committee's (FOMC) April 26-27th meeting strongly suggested the June rate hike scenario was firmly on the table. "*Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen and inflation making progress toward the committee's 2% objective, then it likely would be appropriate for the committee to increase the target range for the federal funds rate in June*," according to minutes. In another reference to the June meeting, officials "*generally judged it appropriate to leave their policy options open and maintain the flexibility to make this decision*" based on how the economy evolves.

As market expectations for a rate rise increased, the US Dollar rallied to a 7-month high, U.S. stocks swung to losses (as a stronger currency erodes the profits of US multinationals) and 10-year Treasuries declined. Federal funds futures are now pricing in a 30% chance for a June rate hike, with odds also climbing to about 95% for a move by year-end, up from 55% on Monday. The calculation assumes the effective fed funds rate will average 0.625% after the central bank's next increase.

With US 10-year notes last yielding 1.85% (up from 1.70% last Friday), it is clear that bond traders were either caught off guard or napping as Fed officials kept talking tough on rates and asserting that each upcoming Fed meeting is a "live" one. And whilst many analysts/strategists believe that the recent bond correction will prove sufficient for now - or that movement in short term rates won't further affect long-term yields much, given lingering global market uncertainties – I remain firmly in the bear camp that foresees a much steeper drop in 10-year US bonds, driving their respective yield above 2.30% before the year is over.

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