Weekly Market Summary

Feb 2nd, 2018

A Week to Remember ! When Ultimately US Stocks and Bonds Got Hammered / Dumped by Traders !

Fadi Nasser - Deputy Chief Investment & Treasury Officer

In our closing market commentary for last year - entitled "*2017 Coming to an End! Time for Reflections & Reality Checks*" - I did point out the obvious, namely that time was running out for bond bulls, especially that:

1- Global growth remains synchronized and extremely favourable over the near-term, whilst public debt burdens stay high (generally quite negative for fixed-income markets, stripping out central banks' QE programmes & market manipulations!).
2- The U.S. is about to sell the most debt in eight years in 2018, with JPMorgan Chase estimating net issuance at $1.3 trillion in 2018, more than double last year's tally (not exactly good timing, given the Federal Reserve's plan to gradually step up the pace at which it shrinks its bond holdings!).
3- US Congress had just passed the most extensive re-write of the US tax code in more than 30 years, with the added fiscal stimulus expected to accelerate growth and spur inflation, adding to bond traders' expectations that the Fed will have to follow through on its tightening projections in 2018.

I also added that I remain firmly in the bear camp, looking for further bond losses and a corresponding adjustment higher in government bonds yields. However, little did I know that the selloff would materialize so quickly and be that severe!

So what has happened in past days to justify this recent acceleration in market turbulence??

First, there was the Federal Open market Committee (FOMC) gathering on January 31st. They came, met, and eventually decided that keeping a lid on inflation did not require another rate hike just yet (the overnight fed funds rate was left unchanged, between 1.25% -- 1.50%). To no surprise, the Fed was sticking with its gradualist path, although the accompanying statement did show more confidence that inflation would get to the 2% target. The decision to stand pat but signal further hikes ahead was unanimous. In her ensuing and last press conference as Fed Chair, Janet Yellen sounded moderately more upbeat, acknowledging recent developments regarding the strength and composition of growth. Overall, the characterization of economic conditions and price pressures suggested that policy makers remain comfortable with their anticipated pace of interest-rate normalization of three hikes (25 bps each) for 2018, as signalled in the last Summary of Economic Projections ("SEP").

And then strong US job data was released two days later, on Friday 2nd February, 2018!

The January employment report was just what the Fed possibly required to justify the next leg of its rate hike path. The monthly job gain of 200,000 and steady unemployment rate of 4.1% were on the strong side, though not particularly remarkable. But a 0.3% rise in hourly earnings, coupled with upward revisions to the prior month, brought the 12-month wage pace to 2.9% (highest year-on-year jump since mid-2009!), clearly indicating that US workers were finally seeing wage growth accelerate. In addition, job gains were broadly based, and the only clear negative was a short workweek of 34.3 hours, most likely weather related. For those who felt the Fed would need more evidence of inflationary pressures to raise rates again in Q1 (next Fed meeting scheduled for March 21st), this data looked to be enough of a wage underpinning to justify a March hike.

For almost a decade now, investors have waited patiently for any hint of inflation in the U.S. economy, a sign the recovery can sustain itself without emergency stimulus from the Federal Reserve. Now they are getting it, and many are shocked at the reaction (central bankers/traders should always be careful what they wish for!). This latest stronger-than-expected employment report, coupled with signs of strengthening wage growth, has sent 10-year US government bond yields up by 6 basis points on the day, and 19 bps higher for the week (last at 2.85%, the highest level in 4 years). Elsewhere, the Dow Jones Industrial Average (DJIA) dropped 665 points on Friday, bringing its five-day loss to almost 1,100 points. Share volatility also surged. The irony for equity bulls is that the selloff was widespread (all 11 industries in the S&P 500 declined in this week, something that hasn't happened since the month of Donald Trump's election) and arrived amid one of the best rounds of corporate earnings upgrades ever seen in the S&P 500. Combined estimates for 2018 profits among companies in the index have gone from $145.90 a share on December 15th to $156.20 on Friday, a rate of increase that is four times faster than any stretch since at least 2012, data compiled by Bloomberg show.

Of all the threats, surging Treasury rates and their implications for inflation are vexing investors the most, with this year's roughly half-percentage-point climb (a jump from 2.40% to 2.85% for UST10s in just 4 weeks!) calling into question a valuation case on equities tied to how much more you get from corporate earnings than in bond interest. For last week, anyway, nobody seemed to care about the presumably positive signals coming from the bond market, the idea that higher yields bespeak rising demand and a stronger economy. Central to the current traders' anxiety is how far stocks have come in so short a time. January's 5.6% gain in the S&P 500 was the biggest for any January since 1997, and using the index's total return it has now risen for 15 straight months. Michael Purves, Weeden & Co.'s chief global strategist, says investors should get used to turbulence given the strength of the market's run up. But it should not derail a bull market that is seven months away from becoming the longest ever. ''*I'll bet you a bag of donuts that by Wednesday or Thursday of next week the equity market starts finding its footing against the backdrop of more stable bond yields*," Purves said. "*And then, like any bottoming process, the market tests it and tests it again and then all of a sudden, boom, new buyers come in*." (with Trump in office, I surely concur with the "boom" allusion in Michael Purves').

One of the mysteries of the recovery from the Great Recession has been how the economy can consistently add over 150,000 jobs each month and the unemployment rate can fall a whopping 6% (from a peak of 10% in October 2009) without a significant acceleration in wage growth. If January 2018 is the start of a new trend, then the mystery may partially resolve itself. Looking at this week's drumbeat, one also can't help but wonder, whether this will prove to be the start of something big?! Warnings about equity and fixed-income valuations have been pouring forth from bears for so long that barely anyone listens anymore. With the S&P 500 up almost 50% in less than two years, and US bond yields still trading well below levels witnessed in 2007/2008, many analysts anticipate further upside for interest rates (especially if traders start betting on aggressive Fed moves beyond 2018, with markets currently fully pricing three * 25 bps this year, but only 36 bps in total for 2019 and 15 bps for 2020),as well as the end of the blissfully easy money that equities have generated over the past 14 straight months.

Not if you ask Donald Trump, though!! According to his chief economic adviser Gary Cohn, "*the president is not concerned, but we are watching it.*" "*We've had a mild back-up in Treasury yields but look at what's going on in the economy, look at what's going on in growth, look at what's going on in corporate earnings, that what's driving the economy*," Cohn said in an interview with Bloomberg Television on Friday. Talking about the US Commander in Chief, could investors be also awaiting one other shoe to drop? That is highly possible. With the approval of President Donald Trump, the House Intelligence Committee released last Friday a disputed GOP memo alleging the FBI has abused its surveillance authority. While there is no direct tie to the stock market, concerns over Washington instability could become another important factor sending investors away from risky assets, including stocks- especially that Democratic lawmakers are now clearly pointing fingers at House Republicans, saying they are "*now part and parcel to an organized effort to obstruct*" Special Counsel Robert Mueller's investigation into Russian interference in the 2016 election. "*Until now, we could only really accuse House Republicans of ignoring the President's open attempts to block the Russia investigation*," Democratic members of the House Judiciary Committee said in the six-page letter released yesterday. "*With the release of the Nunes memo -- a backhanded attempt to cast doubt on the origins of the Special Counsel's investigation -- we can only conclude that House Republicans are complicit in the effort to help the President avoid accountability for his actions and for the actions of his campaign*," the Democrats added.

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