Weekly Market Summary

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Are We Back to Business As Usual ?! Or Just Waiting for the Next Big Shoe to Drop ?!

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Following rollercoaster market sessions last Monday and Tuesday, that witnessed US stock futures trading in a wild and wide range, investors resumed their calm on Wednesday and early Thursday – brushing off the latest round of market volatility (even pointing to it as a healthy correction!). After all, many investors believe that the worse things seem in the market, the better the opportunities are for profiting from contrarian trading. Baron Rothschild, an 18th century British nobleman and member of the Rothschild banking family, was once credited with saying that "*the time to buy is when there is blood in the streets.*" He surely should know: Rothschild made a fortune buying in the panic that followed the Battle of Waterloo against Napoleon in 1815. And whilst most people only want winners in their portfolios, Warren Buffett warns that "*you pay a very high price in the stock market for a cheery consensus"* (in other words, if everyone agrees with your investment decision, then it's probably not a great one! In other words, what I always like to refer to as the imprudent herd mentality trading!).

Going back to yesterday morning, the news out in the market place had started positive, showing that 13 US Senate leaders were in agreement on a two-year bipartisan budget deal that would keep the government funded up to early 2020, lifting spending caps on military and domestic spending and promising an end to the budget crises that have undermined Congress – with a final vote expected in the Senate and House later that day. And whilst the bill was likely to sail through the Senate, expectations were that it would face a tougher road in the House, where conservative Republicans have balked at the effect that the spending bump would have on the fiscal deficit and some Democrats had criticised the deal for failing to address the fate of young undocumented immigrants.

Crazy Markets, Again !!

However, as soon as the NY trading session kicked in - early afternoon GCC time on Thursday - the fear and anxiety that had gripped equity markets earlier in the week suddenly re-emerged, with U.S. stocks plunging this time on concern that rising interest rates will drag down economic growth. President Donald Trump's earlier remark that he would "*love*" to see a government shutdown, suggesting it would work to the White House's advantage, could also have contributed to the negative sentiment. The S&P 500 tumbled 3.8%, erasing its gains for the year (effectively now down 3.5% YTD, from as high as +7.5% YTD posted on January 26th) and putting the equity gauge on pace for its worst week since August 2011, while the CBOE Volatility Index – at 34.00 - was more than double its level a week ago! Ten-year Treasury yields flirted with four-year highs (2.87%) before pulling back as the S&P 500 hit session lows. The yen – last at 109.09 - found traction as a haven from the stock turmoil. This morning, the stock carnage has continued in Asia, tipping markets into declines exceeding 10% from their January highs (bear corrections). China, where retail investors dominate, got hit particularly hard. Japan's Topix benchmark closed down about 2.3%, having pared the worst of its losses. South Korea's index fell almost 2% and Hong Kong's slid about 3.5%. Onshore China gauges at one point exceeded 5% losses on the day. Meanwhile, the dollar weakened against the euro and the pound, and strengthened against the yen.

Earlier this morning, the Senate passed a two-year budget agreement that would boost federal spending by $ 300 billion and suspend the debt ceiling for just one year, as lawmakers sought to end a partial government shutdown that began at midnight after Congress missed a funding deadline. The measure eventually passed 71-28 after a day-long delay prompted by objections from Republican Senator Rand Paul over its cost (The nonpartisan Committee for a

Responsible Federal Budget has stated this latest deal would add a net $320 billion to deficits over a decade, or $418 billion counting the additional interest costs. That is in addition the estimated $1.0 trillion added to the deficit over a decade by the Republican tax cut legislation passed in December!!). It now moves to the GOP-controlled House, where opposition from many Democrats and a faction of conservatives threatens to upset the bipartisan deal.

House leaders are planning a vote in coming hours. Should the bill pass the House, funding would be restored before most government workers arrive at their jobs and financial markets open. A failure would trigger the second full government shutdown in three weeks and would be another signal to voters and investors of Congress's dysfunction.

What Happens Next ?!

This week's mini stock crash can safely be called a technical accident. An orderly repricing of inflation risk – on the back of a sharp jump in US average hourly wages at the time of the non-farm payroll release on February 2nd - blew out of control when large traders joined forces to force out of business a few rather small exchange-traded instruments that bet against volatility.

However, that does not mean that we can fully ignore this week's market bang! There are two more fundamental questions that need to be swiftly addressed: Will equity traders soon start getting more comfortable with a jump up in benchmark U.S. 10-year yields – the highest in four years – that is expected to persist over the medium term? "*There's some big-money players that have really leveraged to the low rates forever, and they have to unwind those trades*," said Doug Cote, chief market strategist at Voya Investment Management. "*They could soon be in full panic mode*." The second key question is whether Treasury bond prices will soon find strong fundamental & technical support, after their persistent drop over the past four weeks; If anything, recent poor 10-year and 30-year US bond auctions - which showed very weak bidding over the past 48 hours - point to the opposite!

As a refresher, during the financial crisis, the Fed bought more than $ 4.0 trillion of Treasuries and mortgage-backed securities. And until recently, the Fed has wanted to keep its portfolio around that size. So when bonds reached maturity, it re-invested the cash instead of collecting the principal. For Treasuries, that meant a natural buyer for government securities sold at regular bi-weekly auctions (the Fed bought about $174 billion last year, according to allotment data from the Treasury Department). However this has now changed: The Fed currently wants to shrink down its balance sheet, but instead of selling securities and scaring everyone, it has decided to simply slow down its reinvestment of principal from bonds that mature. For this year, Fed economists have estimated redemptions (i.e. no reinvestment) of $ 230 billion. Basically, one source of demand is withdrawing from the market, at a time faster wage and economic growth is being witnessed across most of the developed world – whilst investors are readying for the possibility that policymakers at the Federal Reserve and European Central Bank could tighten policy more aggressively than thought at the end of 2017. Additionally, overseas buyers are facing mounting costs to protect their bond positions from swings in foreign exchange markets. And given the potential for trade conflicts and monetary-policy shifts to spur currency volatility around the world, there are plenty of reasons to have and extra insurance in the form of higher yields. "*Unless the U.S. yield curve steepens a lot without the Fed raising rates again, there is little incentive for European bond investors to buy Treasuries on a hedged basis*," Chris Iggo, chief investment officer for fixed income at AXA Investment Managers in London, wrote in a note last month.

And to think that flattening of the US yield curve was amongst the best performing trades for the last 2 months of 2017 !!! (kindly refer to our previous weekly market summaries – released November 10th and November 24th & entitled "*Stubbornly Flat Yield Curves and a Worrying Escalation in Regional Tensions!" & "A Mysterious Curve Flattening Trade That Never Made Sense! Time for a Reality Check!").*

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