Weekly Market Summary

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Are US Yields Headed Much Higher? Or Should We Expect a Possible "Grexit" Soon?

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The last two months have witnessed a big surge in US yields. Ten-year US rates have jumped from a low of **1.85%** in early April (disregarding the depressed print of 1.60% in late January that followed the steep drop in oil prices, a downgrade of global growth by the IMF & World Bank, deflation fears in Europe, implementation of QE by the ECB, heightened market volatility on the back of the CHF de-peg, weak US data, worries about Greece) to as high as **2.50%** earlier in the week (a 35% jump and the highest chart print since October 2014!).

So far, economists and traders remain in denial re this latest market move. To their mind, oil prices remain depressed (WTI last @ 60.0, Brent last @ 63.60), the Greek saga is still unresolved, Ukraine tensions appear to be back on the rise, Middle Eastern geopolitical friction is quite elevated, and economic data is mixed at best (have we already forgotten that 1Q2015 US GDP contracted by 0.7%?). That possibly explains why a recent Bloomberg survey of 73 bank participants had the 2015 year-end forecast for 10-year US yields anchored at 2.50%!

Whilst we don't claim to understand/predict markets better than the army of economists sitting in large US and European banks, it is worth pointing that an economy running close to full employment (the unemployment rate was last at 5.5% versus a peak of 10% in October 2009), with an annual growth rate of 2.8% expected for whole of 2015 and an inflation rate inching slowly but surely above the 2% YoY threshold (by or before year-end) would in normal times witness a 10-year US yield closer to **4.00%.**

However, with Central Bank interference/manipulation reaching new heights and rendering bonds levels/valuations useless as an economic barometer, we do understand that we're nowhere close to normal times and hence formulating a solid view on the future direction of bond prices (inversely on yields) remains at best a humble process (not to mention embarrassing at times). Still caution is required at all times, and hedging some or all of those floating liabilities at current yield levels should remain a top priority for all corporate finance managers.

Elsewhere, a supposedly lackluster and dull end to a relatively volatile week for markets could still be shaken by further threatening headlines relating to the Greek standoff.

US retail sales data released on Thursday afternoon showed a healthy 1.2% MoM increase in April, a sign households are finally willing to put gains from continued job growth and lower fuel prices to work. The number – combined with better-than-expected business inventories & sales data as well as much stronger JOLTS Job Openings – led to most economists boosting their GDP forecasts for the 1st and 2nd quarter of 2015 (1Q2015 last

released at a -0.7% annualized rate might soon be revised up to -0.2%, whilst early estimates for 2Q2015 put the number at +2.8%).

Still, fixed-income markets overlooked this latest confirmation of increased economic activity and decided instead to focus on breaking news relating to Greece (namely that the IMF team was abandoning talks with their Greek counterparts). US and German Treasury bond prices rallied sharply, with yields dropping by close to 12 bps from highs seen earlier in the day.

In the past 24 hours, European Union President Donald Tusk has told Greece's Alexis Tsipras to stop maneuvering and decide whether to accept the conditions on financial aid as the International Monetary Fund's negotiators left Brussels empty-handed. The IMF said that its team flew out after failing to make progress on a debt deal that would help Greece avoid default and cement its position within the euro. Tusk accused Greece of playing games with its future and pressed Tsipras to make concessions to escape economic ruin. "*We need decisions, not negotiations now*," the EU President told reporters in Brussels on Thursday. "***There is no more space for gambling, there is no more time for gambling. The day is coming I am afraid that someone says the game is over***." "The ball is very much in Greece's court," IMF spokesman Gerry Rice told reporters at a media briefing in Washington. "***There are major differences between us in most key areas. There has been no progress in narrowing these differences recently***."

This morning, courtesy of a Bild-Zeitung (a German tabloid) report – markets have woken up to the fact that the German government is no longer ruling out a Greek default after Prime Minister Alexis Tsipras during talks on Thursday did not concede any ground on European Union reform proposals. Citing unidentified people familiar with the government's position, Bild reported that Chancellor Angela Merkel's advisers are in discussion on how to deal with a default, including capital controls for Greek banking clients and a debt cut. Merkel is also responding to pressure from her Christian Democratic bloc as a growing number of lawmakers object to further financial aid for Greece (according to Bild). Last Wednesday's talks with Merkel and France's President Francois Hollande had concluded with Tsipras rejecting proposals such as a higher value-added tax

With time fast running out for a viable solution that would please all parties, markets still remain hopeful for a last minute deal. Nonetheless, one shouldn't underestimate the chances of a big accident happening too. And based on the recent powerful move higher in stocks over past months, it is very obvious that equity traders – while complaining that the world could soon come to an end – continue pouring additional funds into stocks despite the current high valuations!!

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