
Weekly Market Summary

19th of May 2015

The Global Bond Sell-Off is Over ! Long Live Bull Markets?!? - Fadi Nasser

In line with what we rightly predicted in our last economic piece titled *"The New Market Normal: Surreal Events That Keep Recurring"* (where I suggested that any further sell-off in bond markets - especially German bunds - would be met with verbal intervention on the part of the European Central Bank President Mario Draghi, who would step in to calm markets and confirm the ECB's willingness to ensure - within its mandate - that European yields remain low whatever it takes), last Thursday evening speech by the ECB chief to the International Monetary Fund (IMF) provided a late but highly needed support to bond prices that has extended throughout the Friday session.

"The ECB's economic stimulus program is working but needs more time to bring European inflation back to healthier levels and restore consumer and business confidence", Draghi said. He was referring to the EUR 1.1 trillion (US\$ 1.3 trillion) in bond purchases that was unveiled by the ECB at its January 22nd meeting (extending up to end-September 2016) to support economic activity and eliminate deflationary risks within the Eurozone. In fact, earlier last week, the 19 countries that use the Euro currency reported the fastest economic growth in two years (1Q2015 +0.4% QoQ / +1.0% YoY), and Eurozone consumer prices have recently stopped falling (April Eurozone CPI +0.2% MoM / +0.0% YoY, core CPI +0.6% YoY).

But Mario Draghi was not ready to declare victory over Europe's long struggle with economic stagnation. *"After almost seven years of a debilitating sequence of crises, firms and households are very hesitant to take on economic risk,"* he added. *"The bond-buying program will therefore stay in place as long as needed for its objective to be fully achieved on a truly sustained basis"*, and policymakers would implement the programme *"in full"* because it would take time for the benefits to spread to the wider economy.

Stock and bond markets rallied on this latest bullish news (more accommodation and extended low rate policies ... Yippee!), whilst the US Dollar trimmed some of this week's losses against its peers (Euro last at 1.1425 and GBP last at a stunning 1.5725 after trading to a high of 1.5817 on Thursday!).

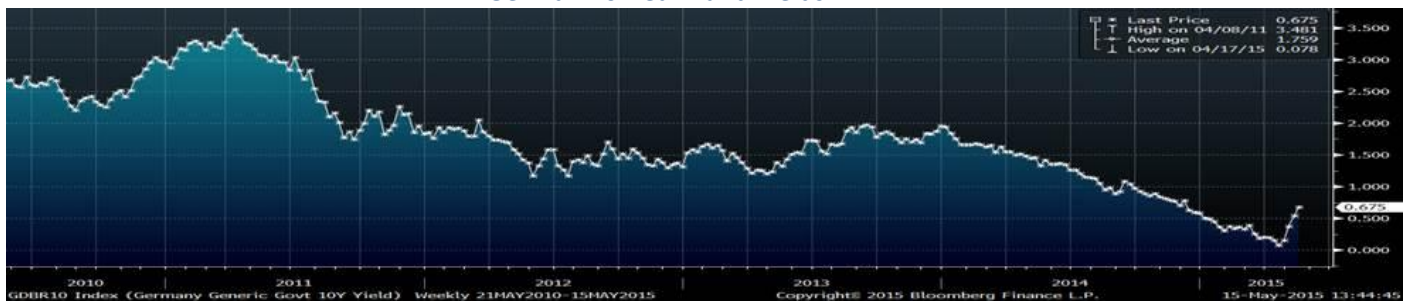
Nonetheless, Draghi admitted that keeping rates low for a prolonged period of time carried other risks: *"I don't want to underplay the attention that we need to devote to risks coming from an environment where rates are too low for too long. One specific risk linked to monetary policy is liquidity risk. The premium on liquidity, when it is abundant, is very low, so people tend naturally to invest in assets which in other circumstances would be considered to be illiquid. This premium is expected to stay low as long as the abundant liquidity conditions last. That's why exiting from abundant liquidity policies has to be done very, very carefully"*

So What Happens Next??

With Central Bank interference/manipulation reaching new heights and rendering bonds levels/valuations useless as an economic barometer, it has become extremely challenging to formulate a solid view on the future direction of fixed-income markets (similarly with equities, credit and commodity valuations). After all, as soon as the European Central Bank embarked upon quantitative easing in 2015, bond prices rose and yields fell (even turning negative in some instances) across Europe. With a central bank committed to buying EUR 60 billion of securities every month, traders/economists began wondering whether any other outcomes were even possible, just in time to be unpleasantly surprised with a 1350% jump in German bund yields within a matter of week(s) (from an all-time low of 0.055% to a brief test of 0.80% earlier this week!).

The recent bond sell-off/correction/"whatever it is" was surely damaging for participants that entered the fixed-income market in the past 4 months. But the move is a lot less damaging when someone considers the journey that the bond market has undertaken on a longer timescale.

German 10-Year Bund Yields



US 30-Year Bond Yields



So after all the despair and heartache over what happened with bonds in recent weeks, two conclusions emerge: First, higher yields are a sign that parts of the global economy are on a glide path to recovery. And second, 10-year German and USD borrowing costs at their current level of 0.67% and 2.20% percent respectively are a lot less worrying than the 0.05% and 1.60% lows they reached earlier in 2015. Maybe - just maybe - the US and Euro regions have avoided the much feared deflation bullet witnessed in late January when WTI oil prices traded to a low of \$ 42.5 per barrel!!

Elsewhere - and in a sharp contrast to the 2013 taper tantrum - risk assets have held up quite well so far despite higher long-term real rates. This is likely due to the timing of the first US hike being pushed further out

(currently the June 17th FOMC is totally priced out, whilst a tiny probability remains assigned for a September 17th first Fed interest rate hike) after a series of disappointing US economic releases in past month.

The market is essentially calling the Fed's bluff! Traders are betting that policy makers would not be able to raise rates this year without disrupting stocks and bonds, something they would really prefer to avoid. So either U.S. policy makers will have to risk another market-wide tantrum (Fed Yellen, Dudley and William still cautioning markets – in recent speeches – that the US economy is improving, Fed policy remains data dependent and every upcoming FOMC meeting is on the table for a possible rate rise), or they will soon give in to traders who embrace the idea of these historically low borrowing costs sticking around for much longer. At least for now, equity traders seem to have opted for the latter scenario, with equities on fire in recent weeks – hardly affected by the recent steep jump in long term yields. The Dow Jones Industrial Average closed last week near record highs at 18,272, whilst the S&P ended at record 2,023 high! The NASDAQ remained comfortably above the 5,000 mark (last at 5,049).

Whether the stock market chooses to sell hard in the coming months (a la recent bond rout of the past 3 weeks!) - on the back of solid economic/inflation data that pushes the Fed to adopt quick and more aggressive restrictive monetary policies - remains to be seen.

One thing is for sure: Recent history should have every market participant expecting the unexpected at all times!!

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