Weekly Market Summary

22nd of May 2015

Tired Hearing About Financial Scandals? … Join the Club!! - Fadi Nasser

This week was expected to be all about the release of minutes for the April 29th FOMC meeting (last Wednesday evening). After all, market participants are still assessing whether the US central bank will be in a position to raise rates for the first time since June 2006 (back then the US Fed hiked the o/n Fed funds rate by 25 bps, from 5.00% to 5.25%) when it meets next on June 17th as some Fed governors had continued suggesting in speeches over past weeks ("every upcoming FOMC meeting is on the table for a possible rate rise"). Instead, the big news came in the form of further market manipulation/rigging!!

On Wednesday, market participants learned that six of the world's biggest banks had agreed to pay US$ 5.8 billion (I would say peanuts compared to generated windfalls over previous years) and five of them agreed to plead guilty to charges tied to a currency-rigging probe, seeking to wind down almost half a decade of enforcement actions. Citicorp, JPMorgan Chase & Co., Barclays Plc and Royal Bank of Scotland Plc agreed to plead guilty to felony charges of conspiring to manipulate the price of U.S. dollars and Euros, according to settlements announced by the Justice Department in Washington. In addition, the main banking unit of UBS Group AG agreed to plead guilty to a wire-fraud charge related to interest-rate manipulation. The Swiss bank, the first to cooperate with antitrust investigators (that's loyalty!), was granted immunity in the currency probe.

The four banks that agreed to plead guilty to currency charges are among the world's biggest foreign-exchange traders. They were accused of colluding to influence benchmark rates by aligning positions and pushing transactions through at the same time. Traders who described themselves as members of "*The Cartel*" used online chat rooms to discuss their positions before the rates were set and suppress competition in the market, the Justice Department said. The scheme was a "*brazen display of collusion*," Attorney General Loretta Lynch said in a statement. "*This Department of Justice intends to vigorously prosecute all those who tilt the economic system in their favor, who subvert our marketplaces, and who enrich themselves at the expense of American consumers,*" she added.

The accords bring the **total fines and penalties paid** by the five banks to resolve the currency investigations to about **US$9 billion**, the Justice Department said. In the settlement with the Justice Department, Citicorp parent Citigroup Inc. will pay $925 million, the highest of the banks penalized. Barclays agreed to a fine of $650 million. JPMorgan will pay $550 million, and Royal Bank of Scotland Group Plc agreed to a $395 million fine. UBS will pay $203 million. Separately, the Federal Reserve imposed fines of more than $1.6 billion on the five banks for "*unsafe and unsound practices*." London-based Barclays will pay an additional $1.3 billion as part of settlements with the New York Department of Financial Services, the Commodity Futures Trading Commission and the U.K.'s Financial Conduct Authority.

So far such news is both frustrating and repulsive. But wait! It gets uglier when you realize that the breaking story that led to a sharp selloff in the value of the Euro - earlier last Tuesday – was communicated by central bankers to selected hedge-fund traders a day before!

On Monday evening, European Central Bank board member Benoit Coeure told a closed-door reception for hedge-fund traders, economists and fellow central bankers that the Bank would probably accelerate bond-buying this month and next, ahead of an anticipated summer lull. Everyone else learned about the plan on Tuesday morning, an appalling breach of the rules concerning selective disclosure. What is not yet known is which other central bankers at the event might have spilled more illicit material information. Almost three full days after the event, a lengthy Internet search failed to produce the text of what those four central bank officials said. According to Mark Gilbert, a columnist for Bloomberg, there do not appear to have been any additional press releases sharing the content of any of the bankers' Monday deliberations with the wider world. Moreover, the event's welcome address was delivered by Swiss central bank board member Thomas Moser: There is no evidence that his comments have been made public, either. Maybe only Mr. Benoit Coeure said something worth sharing, but how can anybody who was not in the room know??

Going back to the Fed minutes, it appears that the economic weakness in the early months of the year has persuaded most Federal Reserve officials that June is probably too soon to start raising the Fed's benchmark interest rate, though such is not a guaranteed outcome should May data – especially payroll, retail sales and inflation indicators – surprise to the upside! After all, officials at the central bank's most recent policy-making meeting, described the slow start to the year as mostly caused by temporary factors like a cold winter and disruptions at West Coast ports, and generally predicted a rebound in activity for the remainder of 2015. "*Most participants expected that, following the slowdown during the first quarter, real economic activity would resume expansion at a moderate pace, and that labor market conditions would improve further*," the minutes said.

However, an account of the meeting - released after the standard three-week delay –also confirmed that most of the Fed officials "*thought it unlikely that the data available by June would provide sufficient confirmation*" that stronger growth had returned. Among the puzzles are the slow pace of consumer spending - with the latest minutes noting that an expected boost from lower oil prices had failed to materialize - as well as the sluggish inflation outlook. Both trends have continued since the meeting. The minutes suggested, however, that policy makers are ready to move as soon as that evidence has accumulated. Surveys of analysts show that most believe the Fed, which sets monetary policy through a committee consisting of as many as seven Washington-based officials and presidents of the 12 regional Fed banks, will start raising rates in September, though some do not expect an increase until early 2016.

Which brings me to my final observation for the week: In December 2002, as George W. Bush's economic adviser and Director of the National Economic Council at the White House, Lawrence Lindsey (also a Governor of the Federal Reserve from 1991 to 1997) suggested out loud that the invasion of Iraq would be a lot more expensive than supporters of it were claiming. Instead of peanuts suggested by the likes of Richard Pearle and Paul Wolfowitz (neocons advisers), it would cost as much as $200 billion, he said. It shook the White House at its foundations - the fact that he had the audacity to say this – and made Lindsey lose his job. So maybe people should listen to him. And maybe, if his record repeats itself, the disaster he warns about is going to be a lot more costly in the end than the worst-case scenario he is now predicting: Lindsey was speaking during a panel discussion on Fed policy at an event sponsored by the Peterson Foundation.

And once again, he dared to say what everyone already knew, but what the financial establishment on Wall Street fights tooth and nail: The Fed has dragged out the normalization of interest rates "*way beyond what is prudent*." He explained that in graduate school, if you suggested that the Federal funds rate should be kept at zero while the unemployment rate is 5.4%, which is exactly what the Fed has been doing, "*you would have been laughed out of the classroom"*. At some point we are going to get a series of bad numbers (for bond markets that is), showing a little higher inflation, and the market is going to say "Oh my God", we are so far behind the curve and force an adjustment that is going to be wrenching," he added. According to his calculus, when this "*wrenching*" adjustment kicks in, it would turn into a market disruption at a level "seven or eight" on a scale of 10, with 10 being the worst.

But that is the guy that warned that the total cost of the Iraq invasion would be US$200 billion, instead of peanuts, and it later turned out to amount to US$2 trillion. So by how much should we assume that he is now underestimating the ultimate debacle, with his prediction of a "wrenching" adjustment of "seven or eight" on a scale of 10? Maybe – just maybe – the market is better off for now not guessing/predicting the answer.

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