Weekly Market Summary

21st of July 2017

Support for Trump & the US Dollar Waning, Euro & Equity Bulls in Full Control!

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Investors betting on synchronized hawkishness from global central bankers received a one-two punch on Thursday. First, the Bank of Japan retained its dovish tilt by reiterating its commitment to monetary stimulus and emphasizing downside risks to the outlook for inflation and activity. In their announced statement, policymakers cut their inflation forecast for a sixth time - implying a need to keep policy very accommodative for a prolonged period of time (fiscal 2019 at a minimum) – and pledged to maintaining the 10-year Japanese government bond yield around 0% (an attractive investment if you ask me, especially if the Japanese Yen weakens further ☺). Elsewhere, the European Central Bank also kept policy unchanged and signaled it would be ready to step up its quantitative easing program if need be. President Mario Draghi said the central bank is "*not there yet*" on inflation, and more discussion on dialing down its stimulus will likely have to wait until the fall. However, in a surprising show of strength, the Euro surged to the highest level against the US dollar in nearly two years and was the best-performing G-10 currency of the day (trading to a high of 1.1679 this morning, last @ 1.1645).

With the Fed in a rate hiking cycle, it appears that those two central banks have taken on the responsibility of keeping global liquidity pumping, in turn pushing various assets like stocks, real estate and bond prices further higher (and rates lower). That assessment was put to test late June (June 27th), when Mario Draghi said he thought the deflation threat was over and that reflation was underway in Europe, whilst a Japanese Finance Ministry source provided optimistic comments on the state of the Japanese economy (following Draghi's lead). Back then, bond markets took that as a first hint toward global tapering of QE and ultimately moving away from zero interest rates; and with that, global interest rates popped: The U.S. 10-year yield jumped from 2.12% to 2.40% in eight business days, while German 10-year bund yields rallied form 0.24% to 0.605% during the same period (a 152% jump in less than 2 weeks, a major setback for the clueless herd!). So once again, central banks are playing the highly sensitive manipulation game: They want to begin paving the way for an end to QE forever, and use public appearances to signal that, but resulting sharp moves in global rates remain too dangerous a consequence, with markets clearly saying not now, not yet – and central bankers having to retract or ease on earlier hawkish rhetoric!

On the currency front, USD weakness can almost certainly be attributed to signs - earlier this week - that the American health-care reform bill was effectively dead in its current form, indicating an epic failure for the Republican Party and a major embarrassment for the US President, whilst casting a cloud on Donald Trump's broader economic revitalization agenda (just in case you had incorrectly thought that Super Mario was responsible for recent currency gyrations, with his smooth Italian magniloquence ☺). "*Any hopes of dollar support from a successful vote on the Senate's health-care bill look to be vanishing after today's news*," said Rodrigo Catril, a currency strategist at National Australia Bank Ltd. in Sydney on Tuesday morning. "*Near term, the dollar path of least resistance is down. We still think the data -- inflation in particular -- will provide the Fed with enough ammunition to hike in December and boost the dollar, but this is a fourth-quarter story*."

And politics in Washington is again at the forefront, after news emerged yesterday that the U.S. Special Counsel was expanding his investigation of Donald Trump. Robert Mueller, heading the probe into potential ties between Donald Trump's campaign and Russia, is now examining the President's business transactions, according to Bloomberg reports - including investors who bought apartments in his buildings. This expansion of the investigation crosses what Trump had just declared a day before to be a "*red line*" in his interview with the New York Times. In the event the President decides to remove the Special Counsel (leaving himself surrounded by Melania, Ivanka and Jared ☺), he would first have to find a person willing to act as Attorney General to do so. Current Attorney General Jeff Sessions, whom Trump ridiculed in his latest New York Times interview - due to Sessions' decision to recuse himself from the inquiry – has recently said he would not quit!

Equity markets for now seems increasingly insulated from political turmoil and shifting monetary policy - both domestically and abroad - as stock indices continue their march higher, while volatility falls ever lower (the VIX equity volatility index is trending at lows not seen since 1993, and the MOVE Treasury volatility index is at its lowest level in its history going back to 1988!). A year after major political surprises, an eerie calm has descended on markets. Fading political risk following France's election of centrist candidate Emmanuel Macron over Eurosceptic Marine Le Pen, a strong US results season, and an improving global economy appear to be helping investors sleep better at night, if recent measures of volatility are anything to go by. However, this stillness was far from being widely anticipated by market economists/analysts, given that 2016 had been marked by worries of a Chinese slowdown, the unexpected election of Donald Trump as US President, huge swings in the price of crude oil, and the surprise result of the EU referendum in the UK, with all these factors previously thought to have large repercussions on markets for years to come!

One of the more enduring myths in Western society is that wars are somehow good for the economy. Stated differently "*a war gives the economy a boost"* (count me firmly in on that theory ☺). Many people see a great deal of evidence to support this saga. After all, World War II came directly after the Great Depression and the 1990 Iraqi war followed a major US recession. Similarly, trading desks' activity/profitability at major US and international banks get negatively impacted by lower trading volatility as it implies that their customers (money managers, hedge funds, institutional and retail investors) are starting to sit on their hands! That would in turn mean that the banks which boasted surges in trading revenues for the opening months of the year - notably Goldman Sachs, Bank of America Merrill Lynch, Citigroup, JP Morgan and Morgan Stanley as well as European banks such as Britain's Barclays - could see their fortunes reverse if people don't start worrying again soon!

Many observers fear that the drop off in volatility could signal the calm before the storm and that a market correction is looming. Indeed, one big investor (and many few smaller ones) appears to be betting that this period of unusually low volatility will not persist for much longer and that markets will soon be plunged into turmoil. In recent months a big buyer of VIX call options - which will increase in value of volatility surges - has drawn traders' attention. The buyer has been nicknamed "*50 Cent*" - the name of an American famous rapper - because the fund tends to buy options that cost around 50 cents (The Financial Times earlier this year reported that 50 Cent was Ruffer, a large London-based investment house founded by financier Jonathan Ruffer). 50 Cent has so far spent more than US$120 MM on derivatives that insure against a market sell-off. With an influential investor making such a bold bet the calm might not last for much longer!

On this uncertain and possibly upsetting annotation, I want to wish all our valuable clients/readers a pleasant summer break! I will be away for the coming 3 weeks and should hopefully resume regular market updates in the latter part of August.

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