Weekly Market Summary

September 3rd, 2021

When the Fed Chair's Ultimate Goal is Simply to Reassure Investors!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

William McChesney Martin Jr. was the ninth and longest-serving Chairman of the United States Federal Reserve Bank, heading the central bank from April 2nd,1951 to January 31st,1970 under five presidents. Martin was a graduate of Yale University, where his formal education was in English and Latin rather than Finance. However, he still maintained an intense interest in business through his father and eventually went on to pursue graduate study in Economics at Columbia University from 1931 to 1937. His first job after graduation was at the St. Louis brokerage firm of A.G. Edwards & Sons, where he became a full partner after only two years. From there, Martin's rapid rise in the financial world landed him in 1931 a seat on the New York Stock Exchange (NYSE), just two years after the Wall Street crash of 1929 at the outset of the Great Depression.

Contrary to President Truman's expectations and throughout the four administrations that would follow, Martin was able to guard the Fed's independence. Over nearly two decades, he would achieve global recognition as an unbiased central banker that was able to pursue independent monetary policies - while still paying heed to the desires of various administrations. Although the objectives of Martin's monetary policy were low inflation and economic stability, he rejected the idea that the Fed could pursue its policies through the targeting of a single indicator, instead making policy decisions by examining a wide array of economic information. As Chairman, he institutionalized this approach within the proceedings of the FOMC, gathering the opinions of all governors and presidents within the System before making decisions. As a result, his decisions were often supported by unanimous votes on the FOMC. More importantly, the job of the Federal Reserve - he famously said - is "*to take away the punch bowl just as the party gets going*," i.e. in other words reduce stimulus by raising interest rates as the economy reaches peak activity and before inflation surges (The "*punch bowl*" metaphor seems to trace back to a speech given on October 19th, 1955, when Martin spoke to a gathering of financiers, who presumably weren't that eager to see the Fed reduce its stimulus! Sounds familiar? 😊)

Pursuing a tight money policy to clamp down on inflation, Martin in mid-1969 ran afoul of Nixon's concern that the Fed was in danger of tipping the nation into recession, a belief that had been publicly stated by conservative economist Milton Friedman. Two days after an October 15th,1969 White House meeting at which Nixon confronted Martin over his tight-money policy, on which Martin declined to yield, the White House announced that Arthur Burns would replace Martin as Chairman of the Federal Reserve on February 1st,1970.

Fast Forward to Fed Chair Jerome Powell's Latest "Mastery" Speech at the Jackson Hole Symposium! A Dovish Taper?!

Federal Reserve Chair Jerome Powell said last week that the US economic recovery has progressed enough such that the central bank could begin slowing down its $120 billion of monthly asset purchases later this year, though it won't be in a hurry to raise interest rates (why the rush? Inflation and asset bubbles under control, with the Fed's preferred measure of inflation - the core personal consumption expenditures index – rising 3.6% in July from a year earlier - the biggest gain since 1991!) "*The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate lift-off, for which we have articulated a different and substantially more stringent test*," Powell noted.

Speaking at the Fed's annual Jackson Hole policy forum last Friday, Powell still sounded a note of caution about employment levels and stuck to the central bank's message that the current bout of inflation is due in part to supply-chain disruptions brought by Covid-19 and likely to be transitory. Powell did not provide a specific timeline for starting scaling back the Fed's $120 billion-per-month in bond buying, a program started last year in response to the pandemic crisis. While the economy is on a strong path forward, the Fed will be carefully assessing incoming data to see how risks like the Delta variant of the virus might impact progress toward its goals, he said (I am guessing the Mu variant will soon be on his agenda ☹). Powell's comments were later echoed by his number two, Vice Chair Richard Clarida, even as the central bank's more hawkish wing (includes Dallas Fed President Robert Kaplan, Atlanta Fed President Raphael Bostic, St. Louis Fed President James Bullard and Kansas City Fed President Esther George) urged the need to start the tapering process as soon as possible.

Early in his tenure as head of the Federal Reserve, Jerome Powell was known for making some incredible communication "gaffes" that roiled markets and left central bank watchers unclear on the direction of monetary policy. Who can forget the time in December 2018 when he said the federal funds rate was still a long way from neutral even after several increases, spurring concern the Fed was out of touch given the clear signs that the economy was decelerating? This time around, however, Powell managed to calm financial markets whilst also acknowledging that it is appropriate for the Fed to start paring back on its stimulus measures and delivering a case study in what does and does not constitute inflation. Markets took the speech in stride, with U.S. stocks advancing to another record high (hopefully not a case of "*the higher we climb in 2021, the harder we fall in 2022!")* and bonds rallying, whilst Treasury yields and the dollar fell. Additionally, measures of inflation expectations held steady, all a sign that Powell hit the right notes in convincing investors that the Fed has things under control.

No one can say now that Powell is out of touch, except for maybe the inflation hawks who were surely disappointed with Powell's latest denial that current high inflation readings and depressed yields remain a real threat to market stability (pick me 😊). Most economists would argue that whatever the Fed does with monetary policy will not fix those supply-chain disruptions, which have nothing to do with an overheating economy. Would a less accommodative stance open the ports in China that have been hit by Covid-19 outbreaks? Would it solve the semiconductor chip crisis that has curbed the production of autos and sent used-car prices soaring? Would it reverse the five-fold increase in shipping-container costs? Would it lower food prices that have soared because of droughts and worker shortages? Would it address the shortage of truckers that have led to higher transportation costs? The answer to all these questions is most likely NO. However, a rapid removal of monetary policy accommodation would only penalize the 5.7 million Americans who are still without a job because of the pandemic at a time when the economy is showing some signs of weakening.

But what about financial market stability? Isn't Fed policy now just fostering excessive risk taking? Pockets of bubbles and excesses are seen almost everywhere, from a 20% YTD increase in equity prices to extremely depressed long-term yields, booming real estate prices and fast rising cryptocurrencies and non-fungible tokens. Powell has taken a lot of criticism from the inflation hawks for his view that the recent rise in prices is transitory as well as for his continuous support for policies tailored for an economic depression at a time US growth and inflationary measures are powering ahead. Former U.S. Treasury Secretary Lawrence Summers suggested earlier this week that Powell's Jackson Hole remarks amounted to a "*serene*" depiction of inflation that is misreading the risks. "*He made a whole set of arguments on the serene side with respect to inflation*," Summers said on Bloomberg Television's "Wall Street Week" with David Westin. "*There's no certainties, but I think the inflation risks are graver than those that the Chairman recognized*." Summers reiterated his view that it's "*bizarre*" for the Fed to still be pumping liquidity into markets with bond buying, also known as quantitative easing, producing "*toxic*" side effects. The central bank ought to have started moving away from QE "*some time ago*," Summers added.

Bill Gross, the onetime bond King, seems to have a similar opinion. In a meandering and sometimes quite edgy investment outlook posted on his website, Gross said longer-term Treasury yields are so low that the funds that buy them belong in the *"investment garbage can*." Ten-year yields are likely to climb to 2.0% over the next 12 months, from about 1.3% currently, handing investors a loss of roughly 3%, he wrote. Stocks could also fall into the category of "*trash*" should earnings growth fall short of lofty expectations. "*Cash has been trash for a long time, but there are now new contenders*," said Gross, who co-founded Pacific Investment Management Co. in the 1970s and retired in 2019. "*Intermediate to long-term bond funds are in that trash receptacle for sure, but will stocks follow? Earnings growth had better be double-digit-plus or else they could join the garbage truck.*"

The market calm of the past few days faces a serious test starting this afternoon! The potential for volatility comes from the fact that when Fed officials gather later this month (September 22nd FOMC meeting), they will release fresh projections for the fed funds rate for the next few years. And with the labour market pivotal for Fed policy now, today's release of the August jobs report is seen as laying the foundation for these forecasts – collectively known as the dot plot - especially as some Fed officials have already been pushing for an early taper. The upshot is that a robust employment reading could have investors pulling forward tightening bets regardless of Powell's efforts last week in his virtual speech at the Fed's Jackson Hole symposium. If the employment report is "*even deemed acceptable, regional presidents will be back on the tape in a flash*," sounding hawkish again, said Jim Vogel, an analyst at FHN Financial. "*And you may have more officials pencilling in a 2022 hike. And that would have to flatten the yield curve*." A weak report, however, would do the opposite - reinforcing the speculation that has lately helped stoke risk-taking sentiment. "*This labour-market report is definitively one of the most important ones in 2021 and carries a gigantic weight in terms of the potential market impact*," said Witold Bahrke, a senior macro strategist at Nordea Investment Management. The Bloomberg consensus forecast for August NFP remains for a healthy increase of 725,000 new jobs (on top of the stellar 943,000 increase in July). Economists also expect the unemployment rate to dip to 5.2% from 5.4%, a new pandemic-ear low, whilst average hourly earnings jump 0.3% month-on-month (3.9% YoY) following a solid 0.4% gain in July.

If you're still confused with the latest Fed's rhetoric, chill out. So are markets! According to the latest Barron's weekly trader column, a strong US payroll later this afternoon is bad news for the stock market. That might seem counterintuitive! Americans, after all, need to work, but if the economy is growing too quickly, the Federal Reserve might need to take faster action to slow it down. As a result, the market wants the jobs numbers to meet - or slightly miss - the consensus estimates for 725,000 new jobs. That would confirm that the recovery is continuing apace despite the disruptions caused by the Covid-19 Delta variant. But a result too impressive (a number north of 850,000) could be viewed as "*too hot*" and prompt concerns that the Fed would reduce monthly bond purchases to $90 billion as early as November, from their current pace of $120 billion, a bad outcome for stocks. Nor would a strong report just impact stocks; A blowout number could also cause the 10-year Treasury yield to trade quickly up to 1.5%, from its current level of 1.30%.

Disclaimer

It is important that you only use this report if you are the intended recipient of this report and you have satisfied yourself that you are eligible to receive such information. This report is provided to you because you are one of our esteemed customers and have previously shown interest in receiving the type of information contained in this report.

The Treasury and Investment Management department of Gulf International Bank B.S.C. ("GIB") have compiled the information in this report. GIB is incorporated in the Kingdom of Bahrain and is licensed by the Central Bank of Bahrain (the "CBB") as a conventional wholesale bank. GIB's head office is located at Al-Dowali Building, P.O. Box 1017, 3 Palace Avenue, Manama, Kingdom of Bahrain.

This report is intended for the accredited investors, as defined in the Investment Business Code of Conduct published by the CBB. This information has not been reviewed by the CBB or any other regulatory authority in any jurisdiction and neither CBB nor any other regulatory takes any responsibility for the correctness or accuracy for the information contained in this report.

The information contained herein is not directed at or intended for use by any person resident or located in any jurisdiction where (1) the distribution of such information is contrary to the laws of such jurisdiction or (2) such distribution is prohibited without obtaining the necessary licenses or authorizations by the relevant branch, subsidiary or affiliate office of GIB and such licenses or authorizations have not been obtained. The recipient of such information is responsible for ensuring that this information has not been received by it in breach of laws and regulations of any jurisdiction.

This report contains publicly available information only, which has only been complied by GIB. The information provided herein is on "as is" and "as available" basis and without representation or warranty of any kind. GIB hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall GIB or its subsidiaries, affiliates, shareholders or their directors, officers, employees, independent contractors, agents and representatives (collectively, "GIB Representatives") be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting there from, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of information or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of GIB or any GIB Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. The information here is, and must be construed solely as, compilation of information (unless expressly stated otherwise) and not statements of fact as to credit worthiness or recommendations or opinions of GIB.

This report does not provide individually tailored investment advice. Any materials contained herein have no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The document is provided for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. GIB makes every effort to use reliable, comprehensive information, but we do not represent that it is accurate or complete. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or developments referred to herein. Recipients should not regard the materials as a substitute for the exercise of their own judgement. Any opinions are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of GIB as a result of using different assumptions and criteria. GIB is not under any obligation to update or keep current the information contained herein.

The value of, and income from, your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realised.

The information contained in this report is just for informational purposes. Information does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. GIB does not intend to provide investment, legal or tax advice through this report and does not represent that any securities or services discussed are suitable for any investor. When making a decision about your investments and business, you should seek the advice of professional advisors.

The report may contain statements that constitute "forward looking statements". While these forward looking statements may represent GIB's judgment and future expectations, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from GIB's expectations. GIB is under no obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise. The historical information is provided for information purposes only. Performance figures are calculated before tax (if any) and after deducting ongoing fees and expenses. The performance figures are historical and past performance is not necessarily an indication of future results. Certain amounts (including %ages) included in this document may have been subject to rounding adjustments. Accordingly, figures may not be an exact arithmetic aggregation of the figures to which they relate. The values and forecasts shown represent our current indicative valuations and forecasts of the relevant transactions, currencies, interest rates, commodities or securities as at the date shown. Any value or forecast shown herein is not an indicative price quotation. We expressly disclaim any responsibility for the accuracy of the values or forecasts shown, any errors or omissions in the report

With the exception of information regarding GIB and save as otherwise specifically indicated, the information set out in this report is based on public information. We have, where possible, indicated the primary source of information. We strongly recommend the recipients consult the primary source of information. Facts and views in this report have not been reviewed by, and may not reflect information known to, professionals in other GIB business areas.

This Report, and the information contained herein (save to the extent that such information is publicly available) is confidential and may not be disclosed by you to any other person outside of your organization without our consent.