Weekly Market Summary

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Are Central Bankers Still in Control as Bond Mania Continues Unabated?!?

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The 2008 financial crisis was an "*avoidable*" disaster caused by widespread failures in government regulation, corporate mismanagement and reckless risk-taking by Wall Street, according to the conclusions of a federal inquiry at the time. The panel that investigated the crisis – the Financial Crisis Inquiry Commission - casts a wide net of blame, faulting two administrations, the Federal Reserve and other regulators for permitting a catastrophic blend: Careless mortgage lending, the excessive packaging and sale of loans to investors and risky bets on securities backed by those loans. "*The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done,*" the panel wrote in the report's conclusions. "*If we accept this notion, it will happen again*." And whilst it accuses several financial institutions of greed, ineptitude or both, some of its gravest conclusions concern government failings. As to the central bank's responsibility, the majority report finds fault with two Fed Chairmen: Alan Greenspan, who led the central bank as the housing bubble expanded, and his successor, Ben S. Bernanke, who did not foresee the crisis but played a crucial role in the response; It criticizes Mr. Greenspan for advocating deregulation and cites a "*pivotal failure to stem the flow of toxic mortgages*" under his leadership as a "*prime example*" of negligence. "*When the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans and the risky assets all came home to roost*," the report found. "*What resulted was panic. We had reaped what we had sown!*"

Fast forward to 2019! A strong sense of Déjà Vu? Surely! … Is the next financial crisis inevitable? Unfortunately, it seems so!

Starting with the Trump-Xi meeting at last weekend G-20 gathering in Osaka, the US President confirmed that trade negotiations between the US and China were '*back on track*' and signalled a positive shift on Huawei; Though he added he was "*in no hurry*" to finish a deal to end the more than year-long spat between the economic powers. Tweeting after a three-day visit to Japan, the US president said he wanted to ensure Washington secured a good trade deal with China and would not sacrifice that outcome for the sake of speed. "*The quality of the transaction is far more important to me than speed*," Mr Trump said. *"I am in no hurry, but things look very good!*" Mr Trump and Chinese president Xi Jinping earlier agreed to resume trade talks after the US president pledged not to put more tariffs on Chinese goods while negotiations continue and China agreed to buy more US agricultural goods. Trump also softened his stance on Huawei, the Chinese telecoms company, noting that US companies could continue selling products to the Chinese telecom giant (after initial US concerns that the Shenzhen-based company could help China conduct electronic spying). After the initial relief "risk-on" rally that pushed equity prices and government bond yields higher as trading resumed on Monday, market investors came to a quick realization that the G-20 summit had not fully resolved the trade tensions dogging the global economy. Yes, some progress had been made at that meeting, in the form of a united front determined to foster economic growth, but many commentators were still downbeat. "*Over the longer-term, translating a ceasefire into a durable trade peace is far from automatic,*" Mohamed El-Erian, chief economic adviser to Allianz, noted. Erik Nielsen, chief economist of UniCredit, said the risk of an "*abrupt downturn because of trade frictions*" was now lower but the relief was still likely to be temporary!

And then there was Christine Lagarde's – head of the International Monetary Fund (IMF) – nomination to become Mario Draghi's successor at the helm of the European Central Bank (ECB)! European and global bond traders cheered on the news, as they bet her choice would extend an era of ultra-loose monetary policy (alias central bank "*manipulation*") in the Eurozone. Bond prices had been on a tear since late last year, as major central banks started switching to a more dovish stance and souring economic data raised fears of a coming recession. Outgoing ECB boss Mario Draghi is readying interest rate cuts and a revival of the bank's bond-buying quantitative easing programme, whilst the US Federal Reserve is also set to trim rates this summer, most likely as early as late-July.

Ms Lagarde's appointment, which has to be rubber-stamped by the European Parliament, is expected to bring more of the same accommodative monetary policy - rather than a shift to the hawkish stance of rival candidate Jens Weidmann, the Bundesbank president. "*Going by her previous support of Draghi's decisions to introduce innovative monetary policies, investors are making the safe assumption that she is in the dovish camp*," said Seema Shah, chief strategist at Principal Global Investors. As a result, European bond yields fell deeper into negative territory over the past 48 hours. The yield on Germany's 10-year bond, which serves as a benchmark for the region, hit a record low of -0.42%, just a whisker inside the ECB's deposit rate of -0.40%. France's 10-year yield sank further below zero, touching -0.13% at one point. Two-year yields across the entire eurozone are now sub-zero (simply Surreal!) The yield on US 10-year Treasuries, already on a major downward path since last November, hit a fresh two-and-a-half-year low of 1.94% yesterday.

Whilst financial markets continue discounting at least three quarter-point Fed interest-rate cuts by year-end - starting with a 25 or 50 bps cut at the July-end FOMC meeting – many observers (yours truly) argue that unprecedented monetary stimulus from global central banks has created a "*fat and slow*" world, dominated by large companies and plagued by a swarm of "*zombie firms*" - those that should be out of business but survive because of rock-bottom borrowing costs. Not to mention that they have also empowered a horde of zombie investors that continue grabbing stocks and bonds at inflated levels, with many buyers in past 48 hours all-too-eager to snap up subordinated Greek bank debt from Piraeus Bank SA – which tapped European capital markets for the first time since the 2008 financial crisis!

It is with such surreal background that traders now eagerly await this afternoon's Non-Farm Payroll release*, forecasted to show stronger employment gains compared to the previous month numbers. Bloomberg consensus is for June payrolls to have risen by a healthy 160,000 (following a "weakfish" 75,000 jump in NFP for the month of May). It will also be worth keeping a close eye on the other important elements of the report, namely the unemployment rate (expected to remain unchanged at 3.6%), average hourly earnings (likely to rise by a healthy +0.3% mom & +3.2% yoy), the participation rate (expected unchanged at 62.8%) and average weekly hours (also expected unchanged at 34.4 hours). A strengthening of the labour market would dampen the chances of seeing a 50bps cut soon, whilst keeping alive a smaller rate cut later this month.

**The US labour market came roaring back in June, undermining the recent dovish shift in Fed rhetoric. The 224K jobs created on the month leaves the trend pace of job gains at a level that is inconsistent with the Fed cutting rates. However, with wages rising a weaker-than-expected 0.2% mom (3.1% yoy), markets remain convinced that rate cuts are coming as early as late July.*

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