Weekly Market Summary

October 5th, 2018

When the Stars Align for a Long Awaited & Well Justified Bond Market Sell-off!
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Is the jump in bond yields for real this time? And does the sharp market sell-off over the past 72 hours signal the end of the bull bond market that has been in place for the past 37 years??

10-year US Treasury Yields (Weekly Chart)

The death of the bond bull market has been predicted by various hedge fund managers and traders over the past 5 years (pick me!), but this week's sharp move increasingly confirms that 2018 could be the inflection year for the era-defining fixed income bull run that began in the early 1980s. The bond market has found itself under pressure for most of this year, as stronger global economic growth has led many major central banks to start cautiously tightening monetary policy for the first time since the financial crisis (many analysts have dubbed this new environment "quantitative tightening"). Still, previous periodic selloffs were always met with strong market demand (blame it on Trump's inflammatory tweets - usually resulting in heightened political/geopolitical/trade concerns and risk-off trading, or central banks' rushed buying of US paper – typically effected at the wrong levels!), allowing bond prices to defy the bearish market consensus and bounce back (mostly confined to a tight 2.78% -- 3.13% range for the UST 10-year yield).

Yet, those previous rebounds – however odd and possibly at times justified – have never stopped us from warning our valuable clients that higher yields were just on the horizon – as outlined in previous Weekly Market Report's quotes (reproduced below):

A Lot of Sad Political Developments & Breaking Financial News... Markets Far From Panic Mode!! - May 18th 2018: *Bond Traders are getting a glimpse of the "Apocalypse". Last year was all about the global synchronized economic recovery! This year may all be about the global synchronized bond slump.*

A Lot of Breaking News.... But Little Surprises! Markets Remain in a Wait-and-See Mode -4th May 2018: *Just when we were done clarifying – in last week's market summary - the damaging impact (on bond prices) caused by a deadly combination of record US budget deficits (over many years to come) and reduced Fed Treasury holdings (i.e. a shrinking central bank balance sheet), U.S. Treasury Secretary Steven Mnuchin stated he was unconcerned about the bond market's ability to absorb rising government debt. "By definition supply and demand will equate," Mnuchin added. [One can only hope it will always equate, or otherwise forget "goodbye" repayment of American sovereign debt! ☺]*

Beware The Writings on the Wall!! What Writings?? Which Wall?? - 27th April 2018*: With US budget deficits expected to balloon over the coming years (implying a Debt/GDP ratio that will soon surpass the 100% mark and continue grinding higher towards infinity ☺), the US Federal Reserve pledging to start trimming its "beautiful" (if you ask Trump!) and enormous balance sheet (currently at $4.5 trillion, versus roughly $ 800 billion before the start of the financial crisis in 2008) and policy makers showing no signs of slowing their tightening (2 or 3 more rate rises expected for 2018, with the next hike most likely coming at the June 13th FOMC meeting), US rates are surely still headed higher. Sooner or later (most likely sooner!), inflation will show its ugly head in Europe - and European yields would then have no choice but to follow their US counterparts higher. Until that materializes, central bankers might want to enjoy whatever credibility, confidence and magic they still do bring to markets!*

Tired of Following Childish & Idiotic Presidential Tweets?! Join the Club!! - 13th April 2018: *The strong and general sense that fiscal stimulus will be boosting the economy further – coupled with strong inflation readings - would have led "in normal times" to a major bond sell-off (surely breaking the 3.0% psychological resistance on 10-year US Treasuries!), a stalling of the recent equity market rally and an improving US dollar. Instead, all we got was little market reaction, with bonds, equities and currencies confined to a very narrow trading range throughout the week. It appears that the bond vigilantes are acting a lot less vigilant these days!*

US Treasuries Finally Give-In & Break Major Levels!! Surely Not the Levels I had in Mind Though!! - 30th March 2018: *A lot of very smart investors have looked very dumb in recent years by predicting a bear market in bonds (pick me again!☺). Of course, bonds have had their ups and downs, but nothing that can really be called a full-on, nasty, 1970s-style selloff. That said, more strategists are expressing concern about the ability of the U.S. to fund the twin budget and current-account deficits; that was also a major concern in the early 2000s, but then the financial crisis came and those worries subsided as the Federal Reserve took control of markets. With the Fed now backing away, those worries will shortly resurface, and market players – as well as our valuable clients - would certainly be better-off adapting to the notion that a combination of improving growth prospects and larger US deficits will sooner or later require higher yields, a weaker dollar, or both to attract foreign investors and domestic interest!*

The question now is whether this latest market move is merely another regular jump in bond yields that quickly dissipates (the bond market has long been suffering from the boy who cried wolf), or the start of a more meaningful, painful bear market for bonds, as many pessimists have long predicted. To better respond to this million dollar question, one has to go through major factors that led to this week's 20 bps jump in US 10-year yields, and assess whether those variables will have a temporary or lasting impact on markets:

A Vibrant US Economy: A batch of superlative data and bullish comments from officials of the US Federal Reserve have hammered home the strength of the US economy. Last Wednesday's fairly optimistic comments by US Federal Reserve Charmain Jay Powell - who signalled he was "*very happy*" about the "*remarkably positive*", "*extraordinary*" and "*particularly bright*" US economy, and saw little on the horizon to quell his optimism - were immediately followed by the release of stellar economic releases (US ISM Non-Manufacturing print of 61.6 is a 21-year high, Initial Jobless Claims at 207,000 are at a record low - boding well for a strong US payroll release later this afternoon). ***[Should stay strong for another year at the very least]***

Rising Wage Inflation: After years of sluggish pay gains, the US and European economies may be starting to work for America and Europe's low-wage workers. When the US August job report was released on September 7th, it showed that both hiring and worker pay had solidly picked up during that month, with the latter registering the fastest wage growth since 2009 – a sign that businesses are now having to compete hard for workers, especially for skilled jobs. A week later, Euro-area second quarter labour costs increased 2.2%, marking the fastest pace since 2012 and underpinning ECB Draghi's comments that the European Central Bank was "*seeing a pickup in nominal wage growth everywhere*".

And if that wasn't enough, Amazon's announcement last Tuesday that it will raise its minimum wage to $ 15 an hour (previously at $11, a 36% increase) was well received by markets and is sure expected to put added pressure on other companies to further lift their pay levels as well (indeed, shares of retail companies such as Best Buy and Kohl's stores fell sharply on the same day, in a sign that investors expect them to have to raise pay to compete with Amazon, a step that would potentially slow their profits). ***[Surely a trend that will last for years to come, given the lagging impact of strong growth on a sustained jump in wages]***

Persisting Oil Rally: December Brent oil has rallied in past week to a high of $86.74 a barrel in London for the first time since late 2014, amid mounting signs that global stockpiles are shrinking, with the outlook for shipments from Venezuela and Iran worsening (the sanctions imposed by the US administration on Iran are having a more severe impact on oil exports than originally thought by many). That prompted the U.S. State Department to take the unusual step of issuing a statement (last Wednesday) asking the cartel to boost production by tapping the supply buffer it maintains in case of unexpected disruptions – even giving a figure for how much more the group could pump -- 1.4 million barrels a day. In his 30 years covering the oil market, Jefferies' analyst Jason Gammel said he can't recall ever seeing anything like the State Department request. "*This is the lowest level of spare capacity in the global system relative to demand that I've ever seen*," Gammel said in an interview on Bloomberg television. "*Spare capacity is moving to a precariously low point and $100-a-barrel crude is a realistic possibility*", he said. ***[More a function of future supplies, as demand remains strong]***

A start to The European Central Bank's Exist Strategy: ECB officials have signalled lately they will only gradually scale back the extraordinary monetary stimulus that has been in place for the past years. Whilst European central bankers are careful to highlight that they will take a measured approach in normalizing policy, they are moving ahead with halving the amount of monthly bond purchases between new and year-end (15 billion euros a month, from EUR 30 billion previously) before phasing out the overall programme by year-end. That is surely expected to put pressure on European bond prices, in turn negatively impacting US Treasuries ***[Permanent]***

Bearish Technical Outlook: For many seasoned technical investors, market indicators currently signal a "major technical breakdown", with the recent sustained break of the 3.13% major resistance point for 10-year UST (last trading at 3.21%) opening the door for a swift move up to 3.50%.

Key impending risks affecting financial markets remain the usual political/geopolitical worries (Syria, Iran,...), emerging markets uncertainties (Turkey, Venezuela, Brazil,…) and trade frictions between the US and the world in general (China in particular).

All eyes will shift this afternoon to the jobs report* for September, with many investors believing it will support the outlook for U.S. growth and Fed tightening, as well as lead to a further jump in bond yields. The deluge of supply coming, as Treasury Secretary Steven Mnuchin has to finance a growing deficit, is also looming on investors' minds. Bloomberg consensus is for September payrolls to have risen by a strong 185,000 (following a sizable 204,000 jump in NFP for the month of September). It will also be worth keeping a close eye on the other important elements of the report, namely the unemployment rate (expected to drop to 3.8%, from 3.9% last month) average hourly earnings (likely to rise by a strong +0.3% mom & +2.9% yoy, in line with the September print), the participation rate (last at a still depressed 62.7%) and average weekly hours (expected unchanged at 34.5 hours).

**September US Payrolls came out a disappointing 134,000. However, cumulative upward revisions for the prior 2 months - totalling 87K - made up for the shortfall versus the consensus forecast, and the rest of the details within the report looked solid as well. The unemployment rate fell two ticks to 3.7% (consensus 3.8%), thanks to a big gain in employment on the household survey. Meanwhile wage growth, which picked up in the prior month, came in line with expectations with hourly earnings rising 0.3% on the month for an annual rate of 2.8%. US yields moved higher, and the USD strengthened following the job release.*

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