Weekly Market Summary

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Could Bond Markets Rally Further ?? Does It Really Matter ?! As Long as The Music is Playing, Get Up and Join the Party !!

Fadi Nasser - Head of Treasury Sales

It seems Charles Prince III will forever be haunted by an offhand remark about "*dancing*". The former Citigroup chief executive infamously said in July 2007, referring to the firm's leveraged lending practices*: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."* In that same interview, Prince told the Financial Times that the party would end at some point but there was so much liquidity it would not be disrupted by the turmoil in the US subprime mortgage market, denying that Citigroup, one of the biggest providers of finance to private equity deals, was pulling back. "*The depth of the pools of liquidity is so much larger than it used to be that a disruptive event now needs to be much more disruptive than it used to be*," he added. "*At some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go the other way. I don't think we're at that point*." A few months after that Financial Times interview - in November 2007 - Prince resigned. In a separate statement, Citi, which had already taken a hit of US$ 6.5 billion from asset write-downs and other credit-related losses in the third quarter of 2007, said it would take an additional US$8 billion to US$11 billion in losses!!

Back then, the former Citigroup chief executive's explanation seemed to boil down to the following: It was a race to keep up with competitors who kept loosening lending standards and Citi could not afford to drop out! However, after having witnessed few months/a year later what is now being perceived as the worst financial crisis/meltdown since the great Depression of 1929/30 - as well as a severe global economic downturn - those comments have become symbolic of banks' failure (central bankers included!) to come to grips with the gravity of financial crisis. Mr. Prince did inform a Financial Crisis Inquiry Commission – on April 8th, 2010 - that he had asked regulators to take action and impose more restrictions. His statement caused a bit of confusion in the room. "*You wanted regulators to 'impose?' So you wanted them to stop you from dancing?*" asked Bill Thomas, the commission's vice chairman and a former Republican congressman. "*Can't you set up structures inside [Citigroup]?*"

Fast Forward to September 7th, 2017: The ECB's quantitative easing ("QE") withdrawal day is once again delayed! The music is still playing and bond traders are undoubtedly dancing!

The European Central Bank meeting on Thursday ended as many previous ones have. The Bank's governing council left policy unchanged (as a reminder, the ECB's refinancing rate is set at zero, while its deposit rate – the interest rate that the ECB remunerates for deposits that banks hold at the central bank - stands at -0.4%), and ECB President Mario Draghi put off any public discussion of the bank winding down its quantitative easing programme in 2018 (i.e. how to end its € 2+ trillion economic stimulus programme) until at least the next meeting on October 26th. Amid rising confidence in the underlying strength of the Eurozone's recovery (the 2017 growth forecast for the Euro area was pushed higher by 0.3%!), Mr. Draghi said the bank was likely to take the "*bulk of decisions*" on how to wind down its € 60 billion-a-month bond-buying programme at its next meeting, following "*very, very preliminary discussion*" by policymakers about how to phase out the quantitative easing programme at yesterday's meeting.

Some economists have worried that the rising euro could supress the Eurozone's strengthening economic growth by making exports more expensive. And whilst Mr. Draghi acknowledged that the currency's recent volatility "*represents a source of uncertainty*" and threatened to cut short the region's export boom, investors were hardly listening. At the end of the European trading day, the euro held above $1.20 and was near an eight-year high against the British pound - at € 0.92 – while German 10-year bund yields settled at 0.30%. "*The ECB will be forced next year to scale down purchases*," said Jörg Krämer, an economist at Commerzbank. "*However, if the euro made further gains, the tapering process could be slowed down*." Mr Draghi said policymakers discussed the trade-offs between winding the programme down quickly or a slower end that would gradually taper bond purchases over several months. Additionally, Mr. Draghi hinted that markets were right to bet against the ECB increasing interest rates before 2019, saying repeatedly that low interest rates would remain in place "*well past the horizon*" of QE. The central bank was also forced to lower its projections for inflation in 2018 and 2019 on the back of the single currency's rise. The ECB now expects inflation of 1.5% this year, 1.2% in 2018 and 1.5% in 2019 (versus previous forecasts for annual growth of 1.3% and 1.6% in 2018 and 2019 respectively).

It surely appears that the ECB has moved a step closer towards winding down its QE programme, though with the care in ground preparation that central banks have learnt to do - especially following the round of volatility and sharp jump in yields caused by the US Federal Reserve's surprising asset tapering signals in early 2013. In the past few months, Mr. Draghi has managed to walk a fine line between reassuring investors and governments that the bank is making preparations to exit from QE while still retaining control over the timing (I usually refer to that as "outright market manipulation techniques by central bankers"!). Ultimately, central banks build up credibility by being as clear as possible on what they are trying to do, how they are trying to do it and what will trigger them to change monetary policy. On at least the first two of these, markets believe that Mr Draghi's ECB has done well! He needs to ensure that the European Central Bank is equally transparent on the third.

Overnight, US Treasuries made further gains, driving yields to their lowest level since Trump's election win and building on their biggest rally since March from earlier in the week. The yield on 10-year US Treasuries dropped to a low of 2.015%, and was last trading at 2.03%. This latest rally in bond prices comes as geopolitical risks centred on North Korea continue to weigh on investors' minds (US President Trump said yesterday that military action was "*not inevitable*" but was something he was considering because the regime was continuing with its nuclear weapons programme) and as Hurricane Irma, the strongest Atlantic storm on record, continues on collision course for Miami over the weekend after devastating a chain of Caribbean islands – triggering the largest ever evacuation in Miami County and threatening to become the most expensive storm in US history. In addition, markets – encouraged by dovish policy rhetoric from various US Federal Reserve officials over the past few days – now strongly believe that the rate hike narrative has been drastically altered following the rise in political/geopolitical uncertainties, along with the little to no inflationary pressures (interest rate future markets currently pricing a 10% chance for a final 25 bps hike in 2017, and an 85% probability for a full 25 bps rate hike between now and December 2018. Those predictions are totally at odds with the Fed's latest rate projections - released following the June 14th FOMC meeting – that showed Fed officials foresee one more hike for this year, and 3 additional 25 bps rate increases for 2018!).

Whether this latest sharp move lower in yields proves to be little more than a knee-jerk reaction to rising geopolitical tensions and natural disasters, or the beginning of a broader bond market rally that squeezes yields further down, still remains to be seen. **At least for now, the music continues playing and bond bulls remain in full control!!**

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