Weekly Market Summary

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Messy and Irrational Markets .... Perfect Time to Plan a Summer Holiday!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

Are we back witnessing the same complacency / irrational exuberance that - at previous times – triumphed and shaped financial markets for months, sending both equity and bond prices roaring to bubbly territory? That surely appears to be the verdict reached by many market observers (pick me!) closely tracking economic news and asset values over the past week or two.

Indeed, market complacency has prevailed in such a persisting fashion lately that it is starting to feel like 2005-2006, when nothing seemed to upset the broader markets. Even skyrocketing inflationary pressures, persisting regional geopolitical fears and ambiguous forthcoming US - China relations have done little to shake the current positive sentiment, a sign that both equity and bond traders are now feeling quite comfortable buying market dips - relentlessly pushing trading ranges higher. The simple explanation may lie in dovish central bankers' messages worldwide, as displayed by the European Central Bank (ECB), US Federal Reserve and the Bank of Japan (BOJ) latest market-friendly monetary statements, and their willingness to step in to support markets and economies - providing a safety net whenever that is needed. At the same time, reassurances by the US president and his G-7 counterparts that their priorities remain to work closely to bring the pandemic to an end and revive economies post- Covid have in turn supported business sentiment and led to full blown risk-on trading.

Starting with central bankers' dovish rhetoric, we learned yesterday afternoon from the ECB Governing Council that emergency bond-buying would continue at a "*significantly higher pace*" than the 14 billion euros ($17 billion) a week at the start of the year – despite substantial upward revisions to the economic outlook. In their discussions on inflation, some members raised the question of whether risks to outlook for price growth could be seen as on the upside given the Eurozone strong economic recovery and spill overs from soaring US inflation. ECB President Christine Lagarde said in her press conference that higher inflation rates will be "temporary" (not to be mixed with Fed Powell's "*transitory*" 😊) and underlying price pressures remain subdued. As she started speaking, the US was publishing figures showing inflation there (CPI) jumped to 5.0% year-on-year in May, stoking concerns that price gains might become entrenched, even if the Fed continues to stress that it expects them to be momentary.

At this point, and based on the latest market price action (the UST 10-year yield dropped to a low of 1.42% following the CPI release, its lowest level since early March, whilst the S&P 500 index printed another record high before retreating late in the session), it appears that there is a lot of money on the notion that US inflation is really transitory, that Jerome Powell and his colleagues at the US Federal Reserve really mean it when they project inflation to drift lower later this year and next, and that their top priority now is to spur a rise in employment. But the confidence with which they are now being backed by investors and fund managers does look most far-fetched. Otherwise, how could anyone comprehend a 15 bps drop in long-term Treasury yields over a week that revealed the fastest annual run in US core inflation since 1992! This may well be transitory (I personally really doubt that), but it is certainly rather alarming. And the market reaction is arguably even more unnerving, and certainly more extreme. For instance, if we define real long-term interest rates as the 10-year Treasury yields minus the headline inflation rate, then real yields have now tanked to -3.6% (yes, minus 3.6%!). These are critical measures suggesting that financial conditions are exceptionally easy and supporting bond and equity traders' willingness to push out the boat a long way (not to mention a current real estate market that feels a lot like the bubble market circa 2006, with its record prices and bidding wars!)

Nonetheless, just when investors think they have it all figured out, the market can and typically does bite! So goes the reasoning of Lloyd Blankfein, the senior chairman of Goldman Sachs since 2019, who previously warned that low market volatility and extended one-way moves are not the "*normal resting state*" for markets. "*Every time I get accustomed to low volatility, like we were towards the end of the Greenspan era, and we think we have all the levers under control and there is low risk in the world, and the market is awash with liquidity that pounces on every aberration in the market, something erupts to remind us that the idea anybody is in control of anything is hubris,"* Blankfein said in a May 9th, 2016 interview with CNBC.

Needless to remind our dear clients/readers that this time will not be much different! For now, markets seem to be just focused on positives, with investors ignoring potential downside risks that could come to play over the coming months and lead to renewed heightened market volatility (VIX and MOVE, two central volatility indicators for stocks and bonds, are last quoted at 15.75 and 48.00 respectively!) With hindsight, it is usually easy to spot the asset class that starts things: In 2001, it was Dot-Com companies; in 2008 it was Real Estate. This time, it is clearly Excess Cash! With all the central bank experiments in the US, Japan, Europe and even the U.K., there is just too much money lying around and that poses a big dilemma: The dot-com bubble burst when it became clear many tech startups would never break even. The U.S. housing market popped after home prices detached so far from income it became obvious further rises were not sustainable. The BIG question now is how can a central bank-led cash bubble burst, when there is an ever-flowing money hose? Add to that, excessive government spending and central banks' "*puts*" that are firmly in place to maintain a solid floor on equity and bond prices (In market speak, a put is a financial contract that is designed to protect against losses. But by promising to slow the pace of rate hikes, pause a tightening cycle, or even cut interest rates in response to a correction in financial markets, a central bank can also raise the expected level of future market liquidity and encourage risk-taking).

The answer to the above query is quite simple and straightforward: Whilst the US Federal Reserve's new approach to managing inflation - unveiled last summer - makes some sense (i.e. achieving an average inflation rate of 2.0% by allowing inflation to overshoot enough to offset previous undershooting), the way the US Federal Reserve is putting this long-monetary policy framework into practice is likely to result in more volatile interest rates and markets - as well as a higher risk of recession. Besides, the new framework does not require the Fed to take such big risks; Instead, central bank officials could set conditions that would allow them to taper Quantitative Easing (QE) before the end of 2021, as well as begin raising short-term benchmark rates sooner (early to mid-2022) and more gradually – without this conflicting with the goal of 2.0% average inflation (they can always pause on rate hikes if needs be!)

Central bankers have unanimously made choices that may be more attractive and popular now because they provide more impetus to a global economy just recovering from the pandemic. But in doing so, they have provided benefits that will come at a potentially much higher cost later (remember 2008 -2009? ☹), a trade-off to which the US Fed / ECB should start paying greater attention – surely before markets decide to go into a tailspin!

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