Weekly Market Summary

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When Your Most Trusted US Banker and Physician Conspire to Destroy the Mirage of Economic Recovery!

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Latest Update on Coronavirus: Confirmed cases last at 7.62 million (from 6.72 million last week), with the death toll from the pandemic almost reaching the 425,000 threshold (424,333 last versus 393,550 deaths the week before). The COVID-19 is currently affecting 213 countries and territories around the world, whilst the World Health Organization (WHO) latest statements provide further confusion as to whether asymptomatic transmission of Covid-19 is very rare, rare or medium (very similar to a previous U-turn on the role masks can play in protecting people from infection back in April! ☹)

A mirage is a naturally occurring optical phenomenon in which light rays bend via refraction to produce a displayed image of distant object. The word's origins are French (*Mirage*) and Latin (*Mariri*), meaning "*to look at … to wonder at*." In contrast to hallucination, a mirage is real and can be captured on camera since light rays are actually refracted to form the false images at the observer's location.

In last week's economic update *("To Infinity and Beyond!")*, we did note that traders and portfolio managers were looking beyond the civil disturbances sparked by George Flyod's killing, even as those protests increase the risk of another wave of coronavirus infections and delay the economy recovery. We also suggested that economic sense was being twisted in all sorts to explain what is going on in the global economy / financial markets and added that economic data was no longer the main driver for the price action in asset prices, especially in the presence of government and central bank's never-ending stimulus measures (the long awaited Jerome Powell Put!). After all, the US Federal Reserve had swiftly cut short-term interest rates nearly to zero, bought hundreds of billions (or trillions maybe?! Who's really counting? 😊) of dollars in Treasuries / mortgage-backed securities and introduced a plethora of special liquidity facilities designed to support markets. Those measures have so far largely worked, easing financial conditions and enabling corporations and municipalities to borrow in the US debt markets. However, they also encouraged risky behavior that officials would normally want to avoid, a problem known as moral hazard! – especially when recipients for some of these programs are zombie traders/companies (highly leveraged hedge funds, real-estate investment trusts, investors in junk-bond funds, heavily indebted corporations,..., and the list goes on and on!)

This week had started where last week left off for financial markets and policy makers, that is trying to assess how much of Friday's surprisingly solid US job report is real and how much of it could end up being a head fake. As reminder, the US labor market started the healing process a month earlier than anticipated by most economists, with 2.5 million jobs added back to the payroll count in May (a small miss compared to Bloomberg's market consensus for a 7.5 million job losses for the month 😊) and the unemployment rate falling to 13.3% versus market expectation for it to jump to a record 19.0%. And whilst equity investors wasted no time waiting for the true answer, seemingly assuming risk assets would gain from either a strong or weak economy (?!) and lifting the S&P 500 to a high of 3,233 on Monday afternoon (unchanged for the year and an astounding 47% jump from the March 23rd lows), policy makers were surely left in a much tougher situation; In addition to analyzing the latest employment data, Fed officials would also have to deal with the developing complexity of the irrational equity exuberance and the significant bear steepening in the Treasury market yield curve (in plain English, a jump in overall Treasury yields that is most pronounced for longer-dated maturities), not to mention the risks to the US and global economy from a second coronavirus wave!

Wednesday's Announcements & Thursday's Epic Market Reversal!

On Wednesday evening (9:00 pm Bahrain time), The Federal Open Market Committee (FOMC) voted unanimously to leave the o/n Fed funds rate unchanged in a range of 0% to 0.25%, with all but two officials forecasting the benchmark rate will remain near zero until at least the beginning of 2023 (the Fed's extremely reliable Dot Plot! Nahh). As for bond purchases, Fed officials surprised some traders by announcing that they will be extending the program in the coming months "*at least at the current pace*", which amounts to roughly $80 billion of US Treasuries and $40 billion of agency mortgage-backed securities a month. Still, this generous central bank support felt short in comparison to some economists' expectations that the Fed would formally mention or implement yield-curve control, possibly setting target yields for certain Treasuries (like two- or five-year maturities, similar to Bank of Japan's practices). "*The usefulness of yield-curve control in the US remains an open question*," Fed Chair Powell said in his opening statement during the ensuing press conference. "*We will continue our discussions in upcoming meetings and will evaluate our monetary policy stance and communications as more information about the trajectory of the economy becomes available.*" Nonetheless, what proved to be most concerning to financial markets was ultimately the Fed's (and Powell's) cautious tone that suggested the US economy is not out of the woods yet and that structural fragility will continue whilst jobs and inflation will remain under historic pressure. Coming on the heels of some V-shape recovery indicators (Non-Farm payroll, ISM non-manufacturing, ...), that was surely not the message euphoric investors were keen to hear!

And then there is Dr. Doom & Gloom Anthony Fauci and his "*candid and trusted*" assessments on the Covid-19 situation. Having served as the director of the National Institute of Allergy and Infectious Diseases (NIAID) since 1984 - overseeing an extensive portfolio of basic and applied research to prevent, diagnose and treat established infectious diseases such as HIV/AIDS and emerging diseases such as Ebola and Zika – Fauci's developing predictions and choice of words to describe the current pandemic were always going to have a material impact on markets. So when Dr. Fauci calls the coronavirus pandemic his "*worst nightmare*" and warns that the deadly outbreak is far from over - in recent online comments to the Biotechnology Innovation Organization (need to check if that one too is sponsored by Bill & Melinda Gates' Foundation 😊) – investors have to worry deeply about the future! The infection won't "*burn itself out with mere public health measures*," Fauci said. "*We're going to need a vaccine for the entire world, billions and billions of doses.*"

With sentiment souring on the back of the Federal Reserve's slightly downbeat economic outlook and mounting signs that a possible second wave could take soon take hold in various US states and other parts of the globe, US and global stocks tumbled the most in twelve weeks - with the torrid surge over the past 2-1/2 months coming to a screaming halt. The S&P 500 sank almost 6%, approaching the 7% threshold that would trigger an exchange-mandated trading pause. Losses in the Dow Jones Industrial Average (DJIA) were even deeper, with the blue-chip gauge plunging as much as 7.1%. Airlines, cruise and travel shares that soared in recent weeks bore the brunt of the selling. This morning, however, European equity indices and US futures are extending gains, signaling a stock rebound is in place as we head for the weekend (Hip Hip Hurray!! 😊)

So why should we worry that all these market ups & downs are happening? Simply because it brings us back to the moral hazard problem: Risky investors win during good times (by taking on more risk and earning higher returns) while the Fed and the US Treasury (or ultimately taxpayers) assume part of the downside risks when there is renewed trouble in financial markets (and believe you me, there will be!). This in turn is likely to encourage even greater risk-taking down the road, making it more likely that investors and markets will need to be rescued again in the not-too-distant future (*To Infinity and Beyond!* 😊)

Whilst this doesn't seem to be a good road to stay on, also getting off at this particular point in time is quite difficult. After all, no one wants to risk a financial market collapse or a depression to teach traders at prominent investment banks and hedge funds a welcomed and desirable lesson! But surely fast changes need to be implemented in place as soon as markets return to complete normality ("*Absher*", as we'd say in this part of the world 😊). That would include enhanced regulation of sources of systemic risk across the financial system and clear communication to all market participants that unsustainable market practices / moral hazard issues would no longer be tolerated.

Unfortunately, when the current crisis fades, the pressure to adopt reforms will wane – meaning big crisis will most likely become bigger and the moral-hazard problem will only get larger!

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