Weekly Market Summary

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Markets Priced for Perfection! Perfect Timing for a Contrarian View!
Fadi Nasser - Deputy Chief Investment & Treasury Officer

In past weeks, markets have solely focused on positives with risk sentiment holding-up very strongly and investors ignoring potential downside risks associated with a renewed climb in Covid-19 cases/deaths, bad news for AstraZeneca and Johnson & Johnson vaccines as well as mounting geopolitical uncertainties globally (yesterday, the Biden administration imposed new sanctions on some Russian debt, individuals and entities in retaliation for alleged misconduct related to the SolarWinds hack and the US election. Prior to that, China's air force sent 25 fighters and bombers over the Taiwan Strait!). Instead, traders and fund managers are cheered by promises of additional monetary and fiscal stimulus (to infinity & beyond!) The end result? Equity markets have continued posting record highs on daily basis (the US DJIA and S&P 500 indices closed both at new record highs yesterday, up 11.1% for the year!), whilst the world's commodities markets have staged a massive comeback – with the Bloomberg Commodity Spot Index last at 444.46, up 12.0% since the start of 2021.

Bond prices, on the other hand, have managed to gain ground (higher prices, lower yields), even after various reports on the health of the US economy came in much-stronger-than-expected! Retail Sales rose 9.8% in March (that was a month-on-month increase!), easily beating economists' already-optimistic projections, the March Consumer Price Index (CPI) jumped 2.6% year-on-year (No reason to panic … it's just temporary! Ask Fed Chair Powell 😊), the Empire Manufacturing Index posted a reading of 26.3 in April (highest level since October 2017) and weekly initial jobless claims were lower-than-expected (positive news for employment), dropping down to 576K the lowest reading since the start of the pandemic. Yet, bond yields fell after these astonishing releases with the 10-year yield down to 1.55% at one point during yesterday's session, whilst 30-year yields dipped 11 bps to 2.22%. That is surely not the typical bond market response, one would expect, to solid economic data! (A hilarious regular news headline I've come across to justify the unjustifiable: *US Treasuries rally as investors look past solid inflation and retail data* 😊)

You see, expectations of a strong economic recovery - combined with optimism over monetary and fiscal stimulus – would usually tend to propel equity prices higher whilst government bonds (including US Treasuries) are supposed to sell-off and push yields higher, either due to rising inflation expectations and/or bets on tighter central bank monetary policy (future rate hikes). This week's bond movement also breaks a trend from earlier this year, when US Treasuries posted their worst quarterly performance in four decades thanks to expectations that the US economic growth would rebound quickly from the Covid-19 pandemic (who knows? maybe few large investors were caught positioned for higher yields and got royally squeezed afterwards!)

Under what is known as modern portfolio theory, one can reduce the overall risk in an investment portfolio and even boost overall returns by investing in asset combinations that are either negatively correlated or not correlated at all. As a result, your highs may not be as high as your friend's, but neither will your lows be as low. However, most financial experts agree that correlations seem to have really changed post-financial crisis of 2008 (and really-really-really changed post the Covid-19 pandemic!). Take for example investors' focus on the stock-bond relationship: Intuitively, a negative correlation between equities and bonds – which has been largely true of U.S. equities and Treasuries since the early 1990s – would suggest that bonds perform well when equities sell off, whereas a positive correlation would be evidence that bonds are not an effective hedge against equity risk. What is key from an investment perspective is that bonds provided needed diversification to equity risk in six of the past seven recessions; The sole exception was 1973, when Treasuries returned

-3.5% during the recession's first half (but ultimately produced positive nominal returns by the end of the recession). That, in turn, implies holding a combination of stocks, bonds and, perhaps some cash and real estate over the long term would do the trick for any conventional investor. But whilst that proved to be the right approach to portfolio diversification during the height of the financial crisis in 2008/09 and the early part of the Covid-19 pandemic - when the historically negative stock-bond correlation held and the rally in bond markets helped to a great extent hedge against a significant equity market sell-off - recent price action would suggest there is more merit in simply going long all asset prices, courtesy the US administration & Federal Reserve's efforts to continuously lift equity and bond markets!

Are equity, commodity and bond markets vulnerable to an imminent correction? And will investors witness a large move lower in their prices over the coming weeks/months?

At least for now, one can safely state that market bulls remain in full control – pricing global markets for perfection and assuming that risk/volatility will further sink over coming months (VIX - a measure of market's expectations for S&P 500 options volatility over the coming 30 days - is last trading at 16.61, a 14-month low). The longer risk-on trading persists, the higher the chance that expansionary monetary policies being conducted today will result in even more impressive asset price bubbles over the short-term. In the equity space, for instance, investors continue to pour a record amount of fresh money into equities amid hopes that vaccines and policy support will bring the economy to normalcy. Their willingness to pay up for earnings has driven the S&P 500's P/E (price to earnings ratio) almost 20% above its peak during the last bull market!

Ultimately, however, all bubbles eventually burst - meaning that extremely elevated asset prices suddenly and sharply decline. Will such correction be witnessed later this year or sometimes in 2022? And will the move lower in asset prices result from massive amount of money printing by the US Federal Reserve that eventually translates in sizable inflation (& pick-up in nominal yields) or otherwise from enormous tax increases (on capital gains, businesses, higher incomes, energy, inheritances and more) planned by Democrats that leads to a fast economic slowdown? Only time will tell!

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