Weekly Market Summary

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Fear & Nervousness Grip Markets in the Last Months of 2018!!
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A disappearing Saudi journalist, messy Italian politics, unknown Brexit talks' outcome, more interest rate hike in the US and a closely watched US mid-term election (on November 6th) are just some of the factors keeping investors nervous and business sentiment depressed. And if that is not enough, China continues suffering from the consequences of an aggressive US trade war, with the latest GDP release this morning showing weaker-than-expected third-quarter growth (still a healthy +6.5% YoY).

For now at least, economic data continue holding up and fears of a swift hard landing in the US - and elsewhere – appear overblown, as monetary policy in Europe and Japan stays accommodative whilst China unveils more measures to boost economic growth (looser monetary policy and cash injections).
Still, what happens in coming weeks remains at best a wild guess!

Below is a summary of major stories that have shaped markets over the past few days (and will continue impacting prices over coming weeks):

Hawkish Fed Minutes: The minutes of the September 25-26th Federal Open Market Committee ("FOMC") meeting confirmed speculation that Federal Reserve policy makers are leaning toward pushing interest rates above levels considered to be neutral, which neither stimulate nor restrain the economy (my direct advise to the Fed is – similar to past years' warning - *if you Can't Walk the Walk, Don't Talk the Talk !!*). "*Participants generally anticipate that further gradual increases in the target range for the federal funds rate would most likely be consistent with a sustained economic expansion, strong labour market conditions, and inflation near 2% over the medium term*," the minutes read. But Fed forecasts are just projections, not a promise! If the economy stumbles, odds are the Fed will react appropriately and ease policy – though their job would be made more difficult should oil prices continue heading higher and inflation appear to be further rising. Policy makers are navigating an environment with a disturbing historical precedence: The unemployment rate is the lowest since the late 1960s, fiscal spending is ramping up and inflation pressure are slowly but surely starting to build up (though recently "cooked" and later released September Producer & Consumer Price Indices revealed another month of tame inflationary pressures! At least investors are safe for now in assuming – as Fed Chair Jerome Powell confirmed on various previous occasions – that inflation will remain tame near the 2.0% target, at a time both total and core CPI numbers are already running at a 2.3% annual rate ☺). The Fed's determination to continue raising rates comes in the face of increasingly heated levels of disparagement from Trump. While most presidents have veered away from public comments about monetary policy, Trump has been vocal in his disdain for what the Fed is doing - even calling FOMC members "loco," openly criticizing Fed Chairman Jerome Powell, and asserting that higher rates are the single biggest threat to the economic recovery.

Messy Italian Budget Proposal: The European Commission ("EC") gave its verdict on Italy's spending plans (2.4% debt/GDP deficit in 2019), saying they are excessive and asking for an explanation, the first step in what threatens to become a full-blown standoff between Brussels and Rome. The European Union's executive body dispatched a letter to the Italian government requesting changes to its draft budget plan by October 22nd. "*We are writing to consult you on the reasons why Italy plans an obvious significant deviation of the recommendations adopted by the Council under the Stability and Growth Pact*," EU Commissioners Valdis Dombrovskis and Pierre Moscovici said in the letter, referring to the bloc's fiscal rulebook.

Both the budget's fiscal expansion plans "*and the size of the deviation are unprecedented*," they added. The letter was delivered by Moscovici, the EU's economics chief, during a meeting in Rome yesterday with Italian Finance Minister Giovanni Tria, and could mark the start of a process which could culminate in a decision by the Commission to issue a negative opinion next week - essentially rejecting Italy's budget - and asking the Italian government to send it back with revisions (something that has never happened before!). As a result, Italian bonds plunged in past 24 hours (the 10-year yield jumping to a 4-1/2 year high of 3.75%!), with the extra yield investors demand to hold Italy's 10-year bonds over comparable notes in Germany touching 335 basis points - the most since April 2013. Deputy Prime Minister Luigi Di Maio, who heads the Five Star Movement, blamed Brussels for the movement, saying in a video posted on his Facebook page that the spread widened "*because the markets think that the government is no longer united*." Di Maio and his fellow deputy premier, Matteo Salvini of the anti-immigrant League, are unlikely to back down: They argue that they were elected to implement expensive measures such as tax cuts, a lower retirement age and new benefits for the poor which can't be put off. Italy needs the extra spending to help boost economic growth, they also note. For his part, European Central Bank ("ECB") president Mario Draghi told EU leaders at a summit in Brussels Thursday that questioning the bloc's rules can worsen financial conditions and damage growth, remarks that are likely aimed at Italy's budget dispute with the Commission. The country also faces credit-rating decisions from S&P Global Ratings and Moody's Investors Service before the end of the month, with both companies ranking Italy just two notches above junk.

That brings me to the central piece of news - at least to my mind - for the week (hard luck for those assuming I would be covering the Khashoggi crisis in my regular market update!)

- *The Positive Update First:* For the fourth time, the Treasury department has denied President Trump what he wants, i.e. labelling China a currency manipulator. In fact, in its most recent report on the exchange rate policies of America's largest trading partners, the Treasury declined to name China, or any country for that matter, a currency manipulator. Instead, as it did in April, six countries made the monitoring list: China, Japan, Korea, India, Germany, and Switzerland. Whilst the results remained the same, the Treasury toughened up its language on China and signalled the potential for further escalation later down the road. It also included this warning: Treasury is concerned about the depreciation of the RMB and will carefully monitor and review this determination over the following 6-month period, including through ongoing discussions with the PBoC.

- *Now the Worrying News:* US Treasury bonds are looking shakier by the day! A staggering 5% drop in US equities last week alone did hardly impact 10-year US treasury yields (lower by just 7 bps) following their jump to a 7-year high the week before! To make things worse, a report released last Tuesday by the Treasury Department showed China's portfolio of U.S. government bills, notes and bonds falling by $6.0 billion to $1.165 trillion in August (18.5% of all foreign-held debt). Japan, which is the second-largest owner of Treasuries, also reduced its holdings to $1.03 trillion from $1.036 trillion a month earlier. Buying government bonds and suppressing long-term interest rates had over the past decade been an important component of the US central bank put (similarly with the ECB, BOJ and BOE). Now as the US Federal Reserve sets the pace for reversing this process (dubbed quantitative tightening), and as markets witness a drop – though still modest - in ownership by China and Japan (by far the two biggest non-US owners of this market), one has to wonder how long the music will continue playing for US bond holders (Check our previous weekly write-up "*Could Bond Markets Rally Further?? Does It Really Matter?! As Long as The Music is Playing, Get Up and Join the Party!!"* - released in early September 2017). As witnessed in past months, a modest rise in US bond yields created some turbulence for global equity markets; A further rise in yields could reflect a stronger economy but may also result from the supply and demand dynamic changing over the next few years. No one really knows if China will continue dumping its Treasury holdings and thus cause massive self-inflicted losses, but we may have seen the peak in its support as a creditor of the US. This comes at a time when, courtesy of Donald Trump's tax reform and the Fed's balance sheet reduction efforts, the US Treasury is going to have to sell a lot more debt in the coming years. The US budget deficit rose to $779 billion during the fiscal year ending September 30th, the highest in six years and is standing at 3.9% of gross domestic product. Additionally, the idea that tax cuts pay for themselves via a stronger economy is starting to look very optimistic from here, and once a growth slowdown kicks in, an already challenging deficit picture will blow out further. With US deficits surely expected to rise in coming years, whilst major foreign buyers of the US dollar and US paper leaving the stage, the worry is that sooner or later US treasury bond prices would start behaving like those of emerging market government paper (no wonder that the 10-year US Treasury / German Bund spread has widened to a record 277 bps this morning, and is expected to broaden further!).

Steven Major, global head of fixed-income research at HSBC Holdings Plc, has consistently separated himself from the crowd by predicting lower Treasury yields. Having been proved right in 2014, forecasting a year-end value for 10-year US yields at 2.25% versus a market forecast for 3.50% (markets did end the year at that same 2.25%, but it was more a case of Ukraine blowing up, Ebola spreading, Da3esh flourishing, oil prices suddenly collapsing,…), the London-based analyst has made it a point to stick to his position and anticipated 2018 year-end 10-year US yield well below 3.00% (with a similar assumption for next year).

Economic forecasting has always been a flawed science, and I expect Mr. Major to soon get a taste for such shortcoming!! ☺

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