Weekly Market Summary

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Will Markets Rally or Sell Off Over Coming Weeks? Take A Wild Guess!
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One of the worst myths out there is that financial markets are always rational and makes sense; That is surely NOT true! The other one is that many investors pretend to fully understand market moves (😊). If that is the case and you have a really good theory about why stocks, bonds, commodities and cryptos sold in tandem on Wednesday before rallying again yesterday (a mirror image of the previous week's price action), then line up next to everyone else who has a really good theory! On any given day or week, the market can make seemingly random moves for reasons that do not make sense: Sometimes bonds go down when they should have gone up, and sometimes entire equity sectors move in one direction or the other for ridiculous reasons! Never assume that just because something happened, it has to make sense because the market is always supposed to make sense; That is simply nonsense! The key is to understand the catalysts that make assets move: If a move has nothing to do with the underlying prospects of the financial instrument you are tracking, then take advantage of that irrationality, not buying into it by chasing it higher or panicking out of it at depressed levels (a la Warren Buffet's mantra: "*Be fearful when others are greedy and greedy when others are fearful!*"). Additionally, here is a dirty secret about financial markets: Much of the time, nobody has any earthly idea why stocks, bonds or commodities rise or fall on any given hour or day. The trouble is that many strategists are paid to explain such phenomena, and so they often resort to that mysterious analytical technique known as "*guessing*."

Overnight, jubilant Palestinians poured into the battle-damaged streets of the Gaza strip, and the blare of air raid sirens fell silent over Israel after the Israeli military and the militant Hamas group halted an 11-day conflict that witnessed devastating Israeli airstrikes and artillery fire that had pounded the territory relentlessly and killed at least 232 people, many of them civilian women and children. It was the fourth major conflict between the two sides since Hamas wrested control of Gaza in 2007 from the West bank-based Palestinian Authority, and the most damaging. Efforts to end the hostilities had intensified in past 48 hours after the US administration raised pressure on Israel to dial back its onslaught. Still, the truce alone will do nothing to address the root causes of the Israeli-Palestinian conflict, making future cycles of violence likely!

Going back to financial markets, analysts have been applying an after-the-fact rationalization to the price action, with a selective approach to hourly headlines. News last week that US inflation had risen 4.2% year-on-year in April, much faster than economists had forecast, increased speculation about the Federal Reserve reducing its $120 billion of monthly bond purchases and led to a sharp selloff in fixed-income/equity markets (by the end of that day, the S&P 500 was down 2.2%, while 10-year UST yields had jumped 8 bps). However, Fed Vice-Chair Richard Clarida was quick to jump to the rescue, saying that "*transitory*" factors related to industry shutdowns in 2020 had pushed price rises above the central bank's 2.0% target but the economy remained "*a long way from our goals*" and prompting a relief rally in both stocks and bonds (dip-buyers report to duty to save stocks from worst week of 2021!). Then again on Wednesday, Fed minutes (for the April 27- 28th FOMC meeting) showed a number of FOMC participants suggesting that if the economy continues to make rapid progress towards the Committee's goals, then it would be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases. Bond prices fell as yields rose before the usual "*Thursday market turnaround"* kicked-in (a "*buy the dip*" mentality that will continue to pay-off as long as the music is still playing!)

Irrespective of the rationale, it is clear that risk appetite is struggling for direction, with one day's gain typically reversing the next. Additionally, the ability of the market to absorb the latest US CPI and PPI upside surprises, as well as hawkish Fed minutes, is remarkable - not to say surprising! The UST 10-year yield – at 1.62% last - is lower than where it was before both releases and the VIX index (the latter represents the market's expectations for S&P option volatility over a 30-day period) is back close to a low reading of 20, whilst equity indices have already recovered most of the lost ground. Considering that the main market driver will remain the oscillation of the market's narrative between the historically strong recovery prospects and the risk of higher inflation, directionality remains quite uncertain at this stage. That should drive volatility back higher, as investors swing from believing the Fed to worrying that its policymakers would sooner rather than later act to combat inflationary pressures, and in the process tighten financial conditions rapidly. "*Either the Fed, at this point, keeps on saying things are temporary, inflation expectations start to rise and the Fed controls the short end of the yield curve, but allow long term rates to rise in nominal and real term. That's one risk and inflation can then get out of control. Or like in 2013, they have to backpedal and say no, there is a problem with inflation and we have to start raising rates sooner than we said, and we could then have a repeat of what happened in 2013*," Nouriel Roubini, CEO of Roubini Macro Associates and professor at the NYU Stern School of Business, noted in a recent interview. "*So either way is risky. Either you're behind the curve, you're going to cause inflation, or if you don't want to be any more behind the curve, and then you signal 'I'm going to tighten,' then you could have a bond market and a credit market crash that could really weaken the economy, if not stall it.* ***It's damned if you do, damned if you don't***."

Soon, bond vigilantes may stop believing the US central bank's assurances that inflation is under control and take matters into their own hands. After all, the US is currently engaged in an astonishing monetary experiment, with the Federal Reserve still conducting quantitative easing even as the annual rate of headline CPI inflation prints well above the Fed's 2% YoY mandate (CPI last at 4.2% YoY, whilst core inflation has risen to a 25-year high of 3%, recording the biggest jump in a single month since 1981). Additionally, the Biden administration is running a budget deficit of 13% of GDP this year even though economists assume that the output gap closed in late April while large parts of the economy are overheating; Unfilled job openings have reached a record high and small firms cannot find skilled workers. Yet short-term interest rates remain anchored to 0% and the Fed continues buying $ 120 billion of bonds each month, directly financing part of Washington's "*war economy*" debt issuance. All are ignoring all the warning signs just as they did in the 1970s. The current Fed regime makes the Greenspan one, which allowed the inflation of the late 1990s stock bubble and encouraged the subsequent housing bubble, look like a model of sober reflection. At some stage, the Fed will have to recognize reality. And bond prices will then fall with a resounding bang!

Worse, market participants will simply stop trusting that the Fed is behaving like a credible central bank. Billionaire fund manager Stan Druckenmiller (better known as the trader that orchestrated George Soros' $10 billion bet that the Bank of England would have to devalue the British pound in late 1992, generating more than $1 billion for the fund) stands already firmly in that camp! He lately warned that "*Fed policy is endangering the dollar's reserve status*," adding that "*I don't think there has been a greater engine of inequality than the Federal Reserve bank of the United States … so hearing the Chairman [Powell] talking about visiting homeless shelters is very rich indeed …"* Mr. Druckenmiller's latest remarks follow an earlier WSJ Op-Ed that "*keeping emergency settings after the emergency has passed carries bigger risks for the Fed than missing its inflation target by a few decimal points. It's time for a change*"

Where do markets go from here? (Still checking, seriously? 😊)

One way to address such difficult/random query is to refer to a comic piece from TS Lombard:

***Game of Two Halves**: Every year must be divided into two. If the economy is weak in the first half of the year, you should assume a recovery in the second half. If it is strong, assume a slowdown. Whatever makes the average of the two halves - there are always two halves - close to 2.0% growth for the US.*

***Economic Shocks**: Whenever something unexpected happens, like extreme weather or a government shutdown, industrial action or trade tariffs, a financial journalist will always want to know what this means for the macro economy. You need an estimate that is high enough to matter, but not so large that it would force you to change your forecast or look obviously wrong within a few weeks. A good rule is that the event will add or subtract 0.3% to/from GDP. After all, this is invariably the answer you get from sophisticated econometric models (the economists who created these models obviously caught onto this idea long before anyone else).*

***Market Forecasts**: This is really hard and it's best to avoid this altogether if you can. If you can't, perhaps because you are an interest rate "strategist", your best option is to choose a forecast slightly higher of lower than the current spot price and then vary it in sync with the latest market trends. If the yields are falling, lower your 12-month forecast slightly. If you look on Bloomberg, you will see that this is exactly what the consensus does. The same approach works for oil prices.*

***Forecasting the Stock Market**: Most of the time the equity market goes up so, to quote a former equity strategist colleague "you need a damn good reason" to forecast it not going up. But you should also think about the response you will get from clients, especially if you work at an investment bank. If you forecast a bear market and it goes up, everyone will think you're a fool. If it goes down, everyone will hate you. But if you forecast a bull market and prices rise, you will become a hero (and if it goes down, nobody will remember because everyone will have got it wrong).*

***And If All Else Fails, Blame "Liquidity":** Liquidity can explain *everything*, it's basically a residual. And since nobody can measure it, you can just infer its presence (or not) from whatever is happening to market prices. It's the equivalent of "confidence effects" in macroeconomics. The political right particularly like the term "liquidity" because it is a convenient way to accuse policymakers of 'distorting' markets without any actual evidence.*

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