Weekly Market Summary

June 21st, 2019

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

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

Indeed, market complacency has returned in such quick fashion lately that it is starting to feel like 2005-2006, when nothing seemed to upset the broader markets. Even surging regional geopolitical fears and an ambiguous US - China trade war outcome has 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 ECB, US Fed, BOJ and BOE's market-friendly monetary statements this week, and their willingness to step in to support markets and economies - providing a safety net and in turn prompting a fast drop in short & long-term market yields. At the same time, reassurance by the US president that a long-awaited meeting with his Chinese counterpart will soon take place (an "*extended*" meeting at the upcoming G-20 gathering in Japan) would have in turn supported business sentiment and led to full blown risk-on trading.

Starting with central bankers' dovish rhetoric, we learned early in the week that Mario Draghi - the Italian gentlemen at the helm of the European Central Bank for just four more months – has all but pledged new stimulus for Europe's flagging economy that possibly includes both interest-rate cuts and asset purchases. Adding strength to that statement was Draghi's declaration that the European institution should not be constrained by its rules restricting the room for manoeuvre! In response, money markets immediately priced a rate cut by September and European bonds enjoyed one of their biggest rallies in recent memory as yields tumbled to record lows across the region. German bund yields sank to -0.33%, just above the ECB's -0.40% deposit rate, while those on French securities dropped below zero for the first time on record. Tuesday's threat of stimulus succeeded where the ECB failed earlier this month in calming/exciting investors and prompted inflation expectations to rise and the euro to fall as the extent of Draghi's pledge opens the door to far more powerful policy action than officials had previously signalled was even possible. The ECB president's remarks also incited a response from U.S. President Donald Trump, who said the drop in the euro prompted by Draghi's remarks is unfair. Draghi's immediate response at the ECB's annual retreat in Portugal was that "*we don't target the exchange rate -- keep this in mind*." (EUR/USD initial reaction on Draghi's dovish remarks was to sell-off from 1.1240 to 1.1180, though the European currency has since recovered back to 1.1305 last).

Then on Wednesday evening, the US Federal Reserve signalled it was ready to lower interest rates for the first time since late 2008, citing "*uncertainties*" that have increased the case for a cut as officials seek to prolong the near-record U.S. economic expansion. Whilst Chairman Jerome Powell and fellow central bankers left their key rate in a range of 2.25% to 2.5%, they dropped a reference in their statement to being "*patient*" on borrowing costs and forecasted a larger miss of their 2.0% inflation target this year (the central bank now expects the headline inflation to grow at a slower pace of 1.5%, versus the 1.8% predicted at its March meeting). "*My colleagues and I have one overarching goal, to sustain the economic expansion*," Powell told a press conference following the decision. He noted that apparent progress on trade talks had "*turned to greater uncertainty*" and many Fed officials "*now see that the case for somewhat more accommodative policy has strengthened.*" The shift followed attacks on the Fed by President Donald Trump for not doing more to bolster the economy and Tuesday's report by Bloomberg News that

the president had asked White House lawyers earlier this year to explore options for demoting Powell from the chairmanship (is this Cartoon President for real?! ☹). Asked about the criticism, Powell said he thinks "*the law is clear that I have a four-year term and I fully intend to serve it*." U.S. stocks powered ahead after the decision and Treasuries erased losses. The S&P 500 index closed at record highs yesterday (2,954) whilst yields on benchmark 10-year US Treasuries fell to 2.03% (breaking the 2.00% psychological level for a brief moment). Fed funds futures now price increased odds of a rate cut at the July meeting (100% probability for a 25bps cut and a smaller 20% chance that the first rate cut in 10.5 years could amount to a bigger 50 bps). Investors also now see around 75 basis points of easing by the end of this year.

Nonetheless, just when investors think they have it all figured out, the market can and typically does bite! So goes the reasoning of Goldman Sachs senior chairman Lloyd Blankfein, 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 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 related to Trump's less market-friendly views, such as his criticism of U.S. trade deals and immigration, as well as widespread rising geopolitical (Iran) and political (Brexit) concerns which will eventually lead to heightened market volatility. 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 Japan, Europe and even the U.S., 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 start-ups 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, with central banks' "puts" firmly in place to maintain a solid floor on equity and bond prices (my view remains that central bank manipulation can and will only end in one big financial mess, most likely in 2020/2021!).

Last, but not least, a quick update on the tense geopolitical situation in the region. The latest news out this morning is that the U.S. has called off military strikes planned against Iran on Thursday night – and earlier approved by President Donald Trump - abandoning a move that would have dramatically escalated strains that are already running high. The attack, ordered after Iranian forces shot down a U.S. Navy drone over the Strait of Hormuz, would have involved airstrikes and was close to being carried out when it was stopped, said one administration official, who was granted anonymity to discuss a national security matter. According to a Reuters report, Trump had warned Tehran via Oman that an attack was imminent. The US president also conveyed the message that he was against war and wanted to talk, and gave Iran a short period of time to respond, the report said. On Friday morning, Iran's Foreign Ministry said it had called the Swiss ambassador, Markus Leitner, into the ministry for talks. The Swiss embassy also represents U.S. interests in Iran, and the Swiss envoy traditionally serves as the conduit for messages between the two nations, which have no diplomatic relations. Airstrikes would have raised the spectre of a far broader conflict in the volatile region, which supplies one-third of the world's oil. Brent oil was unchanged today on the shifting developments, though it remains up a hefty 5.3% for the week.

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