Weekly Market Summary

June 18th, 2021

Better Safe Than Sorry! Possibly with a Big Grain of Salt!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

Individuals say "*better safe than sorry*" or "*it's better to be safe than sorry*" to mean that it is good to be careful - even if it may not seem necessary - to avoid future difficulties. In other words, it is always wiser to be cautious and wary than to be hasty or impulsive with decisions one may later regret. This English expression, meaning exactly what it recommends, has been around since the early 19th century when it was cited in Samuel Lover's novel Rory O'More (1837).

Relying on the above rationale and following frequent suggestions that price pressures will prove temporary, Fed officials somewhat reversed course last Wednesday and acknowledged they weren't so sure any longer. "*Is there a risk that inflation will be higher than we think? Yes,*" Chair Jerome Powell told a press conference. He spoke after financial markets were taken by surprise when policy makers signalled that they expect higher benchmark interest rates as early as 2023. "*There is a lot of uncertainty*," Powell added.

Heading into the meeting, most economists had not entertained a hawkish scenario (the world hawkish, in the context of Fed decisions, refers to a policymaker who is predominantly concerned with keeping inflation under control as well as one supportive of early rate increases to ensure such outcome), as it felt so remote given the past year of non-stop easing, as well as recent Fed assurances that monetary policy would remain extremely accommodative until the US economy shows "*substantial further progress*" (currently portrayed by Fed officials as "*uneven and far from complete*"). After a two-day debate, the central banks' policy committee ("*FOMC*") decided to hold interest rates at near-zero and keep in place the $120 billion a month bond-buying program. Still, officials signalled they expect rates to increase twice by the end of 2023, compared to previous expectations they would stay the same until 2024.

In addition, the FOMC's latest Summary of Economic Projections ("*SEP*", released quarterly) showed an improved inflation/growth outlook for this year and next (for 2021, Fed officials expect the US economy to grow by 7.0%, up from March's estimate of 6.5%; Their projection for 2021 inflation was also upped from 2.4% to 3.4% during the same period!). Fed Chair Powell, speaking at his post-Fed meeting press conference, said that Fed policymakers were "*talking about talking about*" tapering and that there would be plenty of advance warning (I am guessing as plentiful as the 1.0% miss in 2021 inflation projections over the previous short 3-month period 😊). Analysts predict a signal in August, at the Fed's annual retreat in Jackson Hole, Wyoming, with the actual announcement later in the year. Powell also drew a clear line between scaling back asset purchases and eventually raising interest rates, also known as "*lift-off*." "*Lift-off is well into the future. We're very far from maximum employment. It's a consideration for the future. The discussion now is about the path of asset purchases*." Lastly, the Fed chief played down the signal from the dot plot (a chart that effectively shows estimates of what the federal funds rate should be, with members of the rate-setting Federal Open Market Committee each assigning a dot for what they view as the midpoint of the rate's appropriate range at the end of each of the next three years), urging it be taken with a "*BIG grain of salt*!" ("*huge*" would have been an understatement if history is any guide 😊)

We had previously suggested that financial markets were turning messy and irrational. Bond yields had managed to come down sharply from March-highs despite strong evidence that the recovery was picking up momentum. At the same time, financial conditions had remained extremely easy, with equities/commodities on fire, volatility measures at multi-year lows and credit spreads further tightening. Even junk bonds were starting to yield less than inflation! No one really knows what conclusions Jerome Powell and his colleagues at the Federal Reserve came to about all this, but they evidently decided

that it gave them a great opportunity to start the long and potentially treacherous retreat from the pandemic crisis measures put in place more than a year ago.

The market's reaction to the Fed's "*turnaround*" can be summarized as follows:

- **US Rates Jump**: 5-year yields were mostly impacted by the change in the Fed's dot plot (10 bps jump in the 5-year US swap rates, from 0.85% to 0.95%). Additionally, the US yield curved flattened drastically (5s30s spread collapsed 20 bps, last at 121 bps – meaning that 30-year yields are now 10 bps lower than levels traded prior to the FOMC announcement! Mostly to blame on aggressive unwinding of yield curve steepening bets).
- **USD Strengthens**: One of the clearest impacts of the Fed's latest message change is the value of the US Dollar. It has been the best 48 hours in more than a year for the Bloomberg's dollar index, which shows its performance against a basket of 10 other currencies (DXY last at 92.10). After all, if the Fed is more prepared to tighten than previously thought (are they really?), that should strengthen the currency!
- **Commodity Collapses**: Gold prices were hammered on Wednesday and Thursday, plunging by almost 5% from pre-FOMC levels at one point yesterday and precipitating a selloff across precious metals with palladium set for its worst day in over a year (shedding 9%). Gold prices were negatively impacted by a surge in the USD, which erodes bullion's allure for those investors holding other currencies, as well as a jump in US short term yields that raises the opportunity cost of holding non-yielding gold (versus negatively yield fiat currencies 😊). Oil, too, lost a bit of its latest shine as a strengthening US dollar and worsening technical outlook prompted liquidation of large bullish positions (Brent oil last at $72.50, after trading as high as $74.96 prior to Wednesday's Fed announcement)
- **Equities Plunge**: Stock prices have largely dropped over the past 48 hours (mostly Dow Jones components) as investors struggle to interpret the new guidance from the Federal reserve (Is the Fed Put still in place or not? Someone pls confirm urgently!! 😊). The Dow Jones Industrial Average Future index was last trading at 33,500 – roughly 3.5% lower compared to pre-FOMC levels.

What Happens Next?

According to John Authers, senior Bloomberg editor for markets, second thoughts are proverbially best. Another 48 hours on from one of the more surprising Federal Reserve announcements in recent years (even if policy makers did not actually do anything), the market is still working out what to make of it. The final reaction will be key to the long-term success of the Fed's latest policy announcement.

Many observers continue to characterize the outcome of the Federal Reserve's meeting as a "*hawkish surprise*". However, as Mohamed Al-Erian (chief economic adviser at Allianz SE and president of Queens' College- Cambridge) points out, that is only the case if expectations were for a policy deliberation that was totally blind to what has been happening lately on the ground. The Federal Reserve had so far failed to take actual policy actions (a positive for equities and commodities), though it has at least now started to demonstrate that it is taking note of recent positive economic developments, whilst holding on to its "*transitory*" characterization of inflation (a positive for Fed credibility, inflation break-evens and long end of the bond market).

Most important, however, is that the Fed continues to unwisely delay the inflection point for the Fed's ultra-loose policy stance, relative to what is needed. By doing that, chances are higher that the US central bank will continue falling behind the curve, compounding an unnecessary risk facing a recovery that needs to be strong, sustainable and not vulnerable to unsettling financial market instability.

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