Weekly Market Summary

September 24th, 2021

A Strange Calm Before the Storm, Little Impacted by Emerging Black Swan Events!!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

The "*Calm Before the Storm*" refers to an extremely quiet and peaceful atmosphere right before a serious incident or crisis materializes. This saying was originally used by sailors who usually observed that the weather - right before a storm hit – becomes unnervingly calm; The reason for that is that a storm needs warm and moist air to fuel it and that air is normally very stable and causes that feel of stillness or lull. Markets are not much different! The past few weeks have witnessed extreme investors' complacency, with stock markets simply rising a bit every day, bond yields trading in a narrow range and measures of volatility (VIX for equities, MOVE for bonds) slightly above pre-corona lows. The calm comes despite investors adjusting to a world of fluctuating Covid-19 case counts, central bankers' upcoming bond tapering plans, rising political/geopolitical tensions globally – though all is soothed by an ongoing low interest rate environment as well as continuous governments' stimulus.

The theory of "*Black Swan Events*," on the other hand, is a metaphor that describes an event that comes as a surprise, has a major effect (usually negative), and is often inappropriately rationalized after the fact with the benefit of hindsight. In other words, black swan events constitute the rare, unexpected and unknowable developments that are beyond the realm of normal expectations (also known as "*tail events*" in probability theory). The theory was developed by Nassim Nicholas Taleb (a "*smart but arrogant*" Lebanese compatriot😊) to describe unexpected events of large magnitude and consequence, their dominant role in history as well as the psychological biases that blind people – both individually and collectively – to uncertain outcomes and their central role in history.

At present, several risks are competing for the attention of weary investors. Yet, stocks and bonds have been consistently steady and bid, with the "*quiet*" streak extending for several months now (few short-lived glitches along the way) - that it is almost disconcerting! The S&P 500 index is flirting with a record, whilst the CBOE volatility index, or VIX, has dropped to 19 from its high of 85 in March 2020. One-month realized correlation, a measure of how shares have actually moved, has also dropped to the lowest this year. Investors cheered by signs of calm should not necessarily see this as an all-clear! Their current sole focus on positives (a solid global economic backdrop, Biden's administration / Congress promising additional stimulus measures, world's hope that the Covid-19 virus could soon become endemic) is absurdly overvaluing prices of financial assets and a market reversal could soon follow should the investing herd realize the glaring disconnection between the economic/political reality and the valuation of those financial assets in question, in turn prompting them to align their market positioning accordingly.

In such a context, it is safe to note that stormy clouds have been gathering on the horizon in past weeks (slight slowdown in US / European economic data, prospect of reduced monetary stimulus / tighter monetary policies worldwide, rising political pressure in the US and geopolitical uncertainties in the "*greater*" Middle-East, as well as mounting Chinese economic uncertainties), though a sharp market reversal might only be set in motion by random future triggers (a la Evergrande woes, US Congress showdown on the debt ceiling impasse and/or the banning of all crypto-related transactions by the Chinese government earlier this morning)

Below, we leave our readers with a coverage of major stories that have shaped our world/markets this week:

❖ ***It's All About Evergrande!*** Nothing gets Wall Street fired up quite like a sharp reversal in prevailing trends across markets. Hence the excitement in the air that was palpable on Monday when US equities added to the global fall in equities as the liquidity crisis at China's Evergrande shook stock markets in Asia, Europe and the US. The stock sell-off has fully reversed in past days (the usual "buy-the-dip" herd mentality!) as financial regulators in Beijing issued a broad set of instructions to the Evergrande Group, encouraging the embattled developer to take all measures possible to avoid a near-term default on dollar bonds while focusing on completing unfinished properties and repaying individual investors. Another factor that would have supported market sentiment was Evergrande Group Chairman's latest message to staff regarding his firm belief that the company will step out of the darkest moment soon (I am guessing Hui ka Yan reached out to former Lehman Brothers' CEO Dick Fuld to best advise on how to draft such letter 😊). This morning, it appears that holders of the company's dollar bond have been left on edge after the distressed developer gave no signs of meeting a Thursday deadline for an $83.5 million coupon payment. Banks worldwide are trying to reassure investors that their exposure is limited, whilst staff at the firm's electric vehicle business haven't been paid.

❖ ***Jerome Powell Says Fed Taper Could Start "Soon":*** US Federal Reserve Chair Jerome Powell confirmed the FOMC could begin scaling back asset purchases in November and complete the process by mid-2022, after officials revealed a growing inclination to raise interest rates next year. Powell, explaining the U.S. central bank's first steps toward withdrawing emergency pandemic support for the economy, told reporters Wednesday that tapering "*could come as soon as the next meeting*." That refers to the policy gathering on November 3rd, though he left the door open to waiting longer (possibly to infinity & beyond 😊) if needed and stressed that tapering was not meant to start a countdown to lift-off from zero interest rates. "*The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest-rate lift-off*," Powell noted, adding that he didn't expect the Fed to begin rate increases until after completing the taper process, which would wrap up "*sometime around the middle of next year.*"

❖ ***Pelosi Vows to Avert Shutdown as GOP Opposes Debt-Limit Link:*** House Speaker Nancy Pelosi signalled Democrats will avert a government shutdown by passing a stopgap spending bill without a debt ceiling increase in it, amid Republican opposition to linking the two measures. "*Whatever it is, we will have a CR that passes both houses by September 30th*," Pelosi said at a press briefing yesterday, referring to the so-called continuing resolution bill that will be needed to fund the federal government at the start of the new fiscal year on October 1st. The House passed a stopgap spending measure this week that would keep the government open until December 3rd and suspend the debt ceiling until December 16th, 2022. Republicans, however, are expected block it in the 50-50 Senate, where 60 votes would be needed to move it ahead. It is not yet clear when the U.S. Treasury could be on the brink of a default (with government debt to GDP last at 107.60% and fast moving higher, it shouldn't be that far off ☹), adding uncertainty to how quickly Congress needs to act. US Treasury Secretary Yellen has said the government will probably exhaust its ability to avoid breaching the limit at some point in October. Senate GOP leader Mitch McConnell said Democrats have plenty of time to use a partisan approach to raise the debt ceiling without Republican votes.

❖ ***Bond Yields are the Stock Market's Next Problem:*** First it was China Evergrande Group's debt crisis, then it was the Federal Reserve's policy meeting, while in Washington there's been the continuing theatrical show around raising the U.S. debt ceiling. Now there is another pressing item on the list for the stock market to potentially worry about: U.S. Treasury yields! After initially falling following Wednesday's Fed decision, yields on benchmark 10- and 30-year Treasuries surged more than 12 basis points on Thursday. The yield on five-year notes, which is especially sensitive to the projected path of central bank policy, nearly reached a 2021 high. It all

comes amid a backdrop of more aggressive central bank forecasts and actions: Not only did the Fed indicate it is on track to announce a tapering of its bond purchases in November, but the Bank of England raised the prospect of increasing its short-term rate before the end of the year and Norway delivered the first post-crisis rate hike among economies with the world's most-traded currencies. To some investors, though, these moves by central banks are good news: It is because the economy is doing so well! Whilst the sharp move in rates over the past 24 hours has not derailed the broader equity market, elevated rates and general economic optimism were enough to topple trendy investments such as Cathie Wood's flagship ARK Innovation exchange-traded fund (still down more than 20% from its highs). The general principle is that Treasuries are used to calculate the present value of future cash flows; when yields are low, investors are willing to pay up for earnings that may not materialize for years. However, a sub-2.0% yield on the long bond (30-year UST yields last at 1.92%) and a 1.41% rate on 10-year Treasuries are still nothing to write home about, of course, and neither could be considered as a major threat to future equity market rallies. Matters would surely be different when yields eventually break majorly higher (in excess of 50 bps from current depressed levels) over the coming weeks/months.

- ***Brent Crude Futures Settle at Highest Since October 2018:*** Brent crude futures settled at the highest level in almost three years as supplies shrink at a time when a global energy crunch makes it increasingly likely crude will be tapped for power generation. Some of the world's largest oil traders as well as banks are predicting crude prices to surge even higher this year. Vitol Group sees oil rising above $80 a barrel, partly as surging gas prices boost demand for crude in power generation. Goldman Sachs Group Inc. said crude may top $90 if the coming winter in the northern hemisphere proves colder than normal. Brent for November delivery rose $1.06 to settle at $77.25 a barrel on Thursday on the ICE Futures Europe exchange and were last trading at $77.40 a barrel.

- ***JPMorgan Team Says Flows Show the Buy-the-Dip Mantra is at Risk!*** Flow measures for the S&P 500 Index signal that the psychology of buying the dip in U.S. equities is fraying, according to JPMorgan Chase & Co. strategists. An outflow of $11.0 billion from equity exchange-traded funds on September 20th - the biggest on a down day this year outside of quarterly options and futures expirations - is "*rather concerning*" because it is inconsistent with the buy-the-dip behaviour that has helped propel equities higher for months, JPMorgan strategists led by Nikolaos Panigirtzoglou wrote in a note Wednesday. "*Observing flows for signs that this change in behaviour would prove more persistent is important over the coming days*," they said, adding that an inflow on September 21st of $2 billion was "*rather muted.*" The buy-the-dip mantra among retail investors helped to power the near-doubling in U.S. stocks from pandemic-induced lows in March last year. The phenomenon saw the S&P 500 reliably bounce off its 50-day moving average. Panigirtzoglou's team is in wait-and-see mode, saying they need more significant inflows into equity ETFs over coming days to conclude that buy-the-dip is alive and kicking.

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