Weekly Market Summary

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Beware The Writings on the Wall!! What Writings?? Which Wall??

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Earlier this year (first half of Jan. 2018 to be precise), strategists at JPMorgan released a note that strongly suggested US long term yields would be held down by economic fundamentals that "*dictate a slower and shallower path*" for Fed tightening, and by a term premium that "*is more negative in the 10-year sector than at the front end*". Back then 10-year UST rates were hovering in a tight 2.45% - 2.50% range, having ended 2017 at 2.40%. The rest is history!! Fourteen weeks later - and despite a pick-up in market volatility, wide swings in equity prices, fears of US government shutdowns (narrowly averted), mounting trade frictions between the US and its major economic partners, a widening FRA-OIS spread (that negatively impacts current supportive financial conditions) & surreal presidential tweets - the 10-year U.S. Treasury yield rose above 3.00% for the first time since January 2014, breaking out of a months-long trading range amid an onslaught of supply and a Federal Reserve intent on further boosting short-term interest rates. "*It's a big psychological level that has held for quite some time and is a level that global investors are focusing on for direction*," Justin Lederer, an interest-rate strategist at Cantor Fitzgerald, said before the level was breached. "*Once the dust settles, do we hold above that level and continue to head higher in rates, or does the market hold in?*". Guru bond investors Jeffrey Gundlach at Double Line Capital and Scott Minerd at Guggenheim Partners have previously highlighted the 3% 10-year yield as a critical level for the bond market, one that was only exceeded briefly in 2013 and January 2014, toward the end of the bond-market wipe out – also known as the "*taper tantrum*" (i.e. the announcement of the beginning of the end for quantitative easing in the US in late 2013). As a reminder, the yield rose as high as 2.95% earlier in February, before retreating into a lower range (2.73% - 2.90%) for the past two months. But the prospect of a deluge of new government debt finally weighed on the $14.9 trillion Treasuries market, and the rate climbed as high as 3.03% on Wednesday (before retreating back down to 2.98% this morning).

In its daily "Ahead of the Curve" piece released yesterday morning (entitled "Beware the Writing on the Wall!"), the Rates & Credit research team at Commerzbank argued that the US curve is dangerously close to sending a signal that has reliably predicted recessions for more than half a century (i.e. flat to inverted yield curve), and the Euro area leading indicators are now pointing downwards. The note went on to state that this development could become grave for the US and fatal for the Euro area! With a recent warning by the International Monetary Fund ("IMF") - that global debt has reached record levels and that the seeds of the world economy's demise may have already been planted - also fresh in traders' mind, it was only a matter of time before a market influencer jumps in to remind investors that things remain under control and more importantly that the rate tide hasn't shifted upwards - at least not yet!

European central Bank ("ECB") President Mario Draghi – master at communication (I personally give him an A+ just for his sexy Italian accent!☺) and keeping the ECB committee in tune with his leadership – acknowledged yesterday a "*moderation*" in the pace of the Eurozone recovery, but signalled no change in monetary policy. Speaking on Thursday afternoon after a meeting of the ECB's governing council that kept in place the Bank's promise to maintain its asset purchase programme at least until the end of September (another "QE Infinity" pledge, with more than € 2.3 trillion in asset purchases since mid-2015 [billions, trillions…who is counting really?!], and trillions of Euro debt in negative-yielding territory), Mr. Draghi said there had been "*a loss of momentum that is pretty broad based across countries and all sectors*". But he added that his overall assessment was one of "*caution tempered by an unchanged confidence*" of moving towards the ECB's inflation target of just below 2%.

Analysts said that Mr Draghi's guarded language suggested that the ECB may wait until July - a month later than previously expected - to provide the markets with updated "*forward guidance*" on its plans to phase out the crisis-era stimulus. "*Better safe than sorry was the motto of the day*," said Dirk Schumacher, economist at Natixis, a bank. The ECB president also added that "*some normalisation was expected*" after several quarters of above-average growth, and that temporary factors - including cold weather, strikes and the timing of Easter - might have played a role. But he cautioned that some indicators could suggest "*a more durable softening in demand*". "*The risks surrounding the euro area growth outlook remain broadly balanced,*" Mr Draghi noted. "*However, risks related to global factors, including the threat of increased protectionism, have become more prominent*." In a formal statement that was word for word the same as its March communique, the Bank's governing council also reiterated it would keep interest rates at record lows "*well past*" the end of the quantitative easing programme. The ECB's benchmark main refinancing rate is zero, while there is a negative interest rate of -0.4% on a portion of lenders' deposits held at central banks. The Eurozone's central banks are set to reveal new forecasts for economic growth and inflation at the governing council's next meeting in June.

For those analysts who speculated that maybe – just maybe – the ECB could surprise on the hawkish side and sound more optimistic on its outlook for future growth and inflation in the Eurozone (especially in the context of a weakening Euro in past days, and fast-rising commodity prices in past months), the ECB decision came surely as a total disappointment! Draghi's key message was that the ECB has to stay prudent, persistent and patient while euro-area inflation remains subdued. The central bank's own forecasts do not see consumer-price growth returning to the goal of just-under 2% until at least mid-2019 (the ECB will be revealing new forecasts for economic growth and inflation at its governing council's next meeting on June 14th). As a result, market reaction was very orderly and even cheerful: Traders piled into European government bonds and stocks (the beauty of excess liquidity!) and sent the euro markedly lower (last at $1.2085, down from a high of $1.2410 just 10 days back!). German 10-year bund yields sold-off sharply, and were last sitting at 0.56% (again surreal, especially taking into consideration German's annual inflation @ +1.6% and annual growth running above 2.3%!).

With US budget deficits expected to balloon over the coming years (implying a Debt/GDP ratio that will soon surpass the 100% mark and continue grinding higher towards infinity ☺), the US Federal Reserve pledging to start trimming its "beautiful" (if you ask Trump!) and enormous balance sheet (currently at $4.5 trillion, versus roughly $ 800 billion before the start of the financial crisis in 2008) and policy makers showing no signs of slowing their tightening (2 or 3 more rate rises expected for 2018, with the next hike most likely coming at the June 13th FOMC meeting), US rates are surely still headed higher. Sooner or later (most likely sooner!), inflation will show its ugly head in Europe - and European yields would then have no choice but to follow their US counterparts higher(worth noting that the 10-year U.S. yield advantage over Germany – currently at 240 bps - has reached the highest since the fall of the Berlin Wall in 1989!).

Until that materializes, central bankers might want to enjoy whatever credibility, confidence and magic they still do bring to markets!!

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