Weekly Market Summary

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The Federal Reserve's Credibility is at Stake! Long Live the US Fed!!

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Market sentiment is softening as the Jackson Hole Symposium kicks-off and investors remain nervous about a potentially hawkish tilt by US Fed Chairman Jerome Powell. Adding to nerves were the US House's adoption of a $3.5 trillion budget resolution on Tuesday after a White House pressure campaign and assurances from Speaker Nancy Pelosi helped unite fractious Democrats to move ahead on the core of President Joe Biden's economic agenda, as well as a 25bps hike by the South Korean central bank (BoK) on Thursday morning (from 0.50% to 0.75%), the first central bank of a major Asian economy to raise rates. Contrary to the Reserve Bank of New Zealand (RBNZ) - which opted last week to shelve a widely anticipated 25bps increase in its benchmark rate after a national lockdown injected last-minute drama - the BoK's bold move showed that despite rising infections, a central bank can still hike rates!

The 27-28th August Jackson Hole central bank gathering is effectively the Fed's looming opportunity to share its plans for policy normalization with the markets. Last year, Fed Chair Powell and his colleagues opted for a radical new strategic framework: Allow inflation to overshoot the Fed's 2.0% goal by a bit, for a while (referred to as "*flexible average inflation targeting*") - following periods of underperformance - and use super loose monetary policy to try to push unemployment down. This time around, the economic picture looks much different, thanks in no small part to a $1.9 trillion front-loaded budget boost from President Joe Biden and more money printing by the Fed. In addition, reality has dealt Mr. Powell a different and unexpected challenge: The biggest inflation spike in decades (*transitory, you might be told!* 😊)

Investors will surely be paying close attention to the Fed Chair's words and tone. Whilst Mr. Powell is not expected to announce a clear plan to begin tapering the Fed's bond buying program ($120 billion in monthly purchases of government and mortgage securities), his remarks will be scrutinized for any fresh indication of his thinking. Short of making a formal announcement, he should still state his preference for bond tapering to start soon and be completed by the spring (mid-2022 latest), whilst sticking to his patient, data-dependent rhetoric. There is a lot at stake for the Federal Reserve, and Jerome Powell specially, in getting it right. The Fed Chair's four-year reign as central bank head ends in February 2022 and President Biden has yet to announce whether he will nominate the veteran monetary policy maker for another term or choose to replace him, in the middle of the debate over how long to keep ultra-stimulative policy in place (hopefully a smoother decision compared to the latest US withdrawal fiasco in Afghanistan! ☹) Treasury Secretary Janet Yellen has told senior White House advisers that she supports reappointing Powell, based on a Bloomberg report last Saturday.

For many economists/strategists, the key question is whether it really make sense to bring quantitative easing to a close, now that the delta variant of Covid-19 is threatening the economic recovery and delaying the plans of many businesses to get their employees back to work and overall operations back to normal. After all, didn't the organizers of the Jackson Hole event cancel their initial plans for an in-person gathering "*due to the recently-elevated Covid-19 health risk level*" and switch at short notice to a virtual format? However, such concerns are totally misplaced in my opinion and the US Federal Reserve (along with other G-7 central banks) should look to phase out QE the soonest. On balance, the primary goal of Quantitative Easing was to press down long-term interest rates, support aggregate demand and asset prices. The Fed's promise to keep buying bonds for an overly extended period made this push more forceful, which was appropriate after confidence slumped at the start of the pandemic in early 2020. At the moment, however, lack of demand is not the problem and the supply-side disruptions - along with the excessive flow of central bank liquidity - are pushing up prices and depressing consumer confidence, rather than boosting output and jobs. The Fed's preferred measure of inflation

(PCE core Deflator) stands at 3.5%, well above its 2.0% target (core CPI up 4.3% YoY!), whilst the unemployment rate has reversed sharply lower (last at 5.4% versus a post-Covid peak of 14.8% in April 2020!) - with many employers finding it very hard to fill vacancies. Asset prices have surged, and the risk of bubbles and financial instability is growing fast. All this suggests it is past time to start dialling back the Fed's commitment to maximum stimulus, especially that the costs of further extension by far outweigh the benefits (refer to our anticipatory "*When Benefits Outweigh the Risks*" weekly market piece released back in late-April 2021). In other words, QE for now has had its day!

Where Do Markets Go From Here?

Ask Wall Street strategists few months back where stocks, bonds and commodities will go and the answer will almost be, higher. That is not the case now! A majority currently expects the S&P 500 index and Treasury bond prices to fall heading into the year-end, though forecasting uncertainty remains abnormally high. Investors hoping for more clarity from professional predictors, 18 months after the pandemic upended financial markets, are out of luck - as the number of major concerns that need accounting for virtually precludes a tighter consensus.

With the Federal Reserve inching toward cutting its bond purchases by year-end at the same time as new virus variants threaten to slow the global recovery, playbooks that worked for over a year have started to look dated. "*We can point to a number of positives in the economy that are supportive of risk assets. At the same time, there are plenty of issues that are too close to call, and the macro-outlook could vary widely depending on which way the coin lands,*" said Adam Phillips, managing director of portfolio strategy at EP Wealth Advisors. Sky-high valuations and the S&P 500's 100% rally from the pandemic low add to the difficulties facing strategists. For some, the surge in corporate earnings justifies the elevated prices that have crushed anyone daring to bet against stocks; Others say the recovery faces too many obstacles, including margin pressure from inflation and President Joe Biden's proposed tax hikes, to warrant faith that companies will continue to deliver.

Take Mike Wilson as an example. The chief U.S. equity strategist at Morgan Stanley, just widened his forecast range, saying his bull case calls for the S&P 500 to jump to 4,800 by June 2022, a gain of 8% from Friday's close, while the bear case puts the index at 3,700, a 17% plunge. All told, the 1,100-point range between the two scenarios is almost double what he had envisioned previously. In the bond market, strategists have been scrambling to keep up with a slide in long-end yields. Goldman and JPMorgan analysts both lowered their year-end targets for 10-year yields after the benchmark rate dropped as low as 1.13% (it peaked at 1.75% in late March), whilst strategists at Bank of America now see 10-year US government yields either sliding below 1.0% by year-end, or surging as high as 2.0%, from a current level of about 1.34% (readers have been warned 😊).

Should the Fed Chair sound cautious this afternoon (he can be quite annoying when he does that 😊), that could support risk sentiment (higher asset prices) at the expense of the USD in the near term. Any risk sentiment rebound may prove only temporary, though, in view of the key US data releases next week (Non-Farm Payrolls, ISM Manufacturing and Services, Conference Board consumer confidence). Similarly, while story after every news story shows us just how keen every economist / investor is about what Chair Jerome Powell may tell us from the virtual event, option markets are decidedly less excited with option volatility for foreign exchange, bond and equity derivatives drifting lower over the past few days.

To end the weekly market update on a happy (or sad, your choice) note, here are two surreal statistics worth keeping a close eye on when marking Fed (and other central bankers') actions:

- The world's central banks have printed $834 million each and every hour of each and every day for the past 18 months to keep the global economy up and going! That is correct. $834,000,000 per hour for the past 547 days (18 months)! The Fed alone has put in a total of $4 trillion, or $309 million per hour.

- As goes the balance sheet, so goes the stock market: More money has poured into stock funds within the past several months than the previous 12 years combined! If market cap ranges between 75% and 90% of GDP, the stock market is usually considered fairly valued. Today's market cap-to-GDP ratio? A record 205%. Only a $40 trillion economy would justify today's gigantic valuations (the US currently running a $22 trillion economy).

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