# Weekly Market Summary

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## The Tide is Slowly but Surely Turning!! Where Have All the Bond Vigilantes Gone??

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Financial assets' movements in past days have suffered from late spring doldrums, especially that news flows have remained light and markets stayed quiet. Yet, all market participants expect the Federal Reserve to face a big and volatile summer ahead as it starts providing more clues about when the ultra-easy monetary policy measures put in place during the height of the pandemic finally start to unwind.

Investors got their first indication on what is in store for the remainder of 2021 when Treasury Secretary Janet Yellen roiled financial markets earlier this month by suggesting that rate hikes may be needed to stop the economy overheating as President Joe Biden's spending boost growth (Mrs. Yellen later told a Wall Street Journal CEO Council that she sees no inflation problem brewing and that any price increases would be transitory, adding that her earlier comments were neither predicting nor recommending a rate rise!) Then it was the minutes from the central bank's last policy meeting (April 27- 28th) that featured a tapering discussion in which some members said it would soon be time to talk about rolling back some of the tools the Federal Reserve has used to support and guide the economy. The critical part of the meeting summary noted that "*a number of participants suggested that if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases.*"

To the market's ears, the passage did spark initial talk of *"tapering,"* a word that generally makes investors nervous as it means the Fed will start reducing the $120 billion of bonds it buys monthly to support markets. Fed officials have pledged plenty of warning before an actual tapering happens and many Fed governors still insist that talks of reductions in bond purposes remain too premature. However, the presence of such talk at the April meeting has already sent the first signal that a reduction in purchase is on the table, with more information to be made available over coming weeks/months.

Market consensus remains that the Fed will continue dropping regular hints between now and when central bankers gather in August at their symposium in Jackson Hole, Wyoming, an important financial gathering arranged annually by the Kansas City Fed. That process has already begun: Dallas Fed President Robert Kaplan has lately been reiterating that that Fed tapering should start "*sooner rather than later*," and Philadelphia Fed President Patrick Harker last week used the same expression to describe his position (both gents are non-voting members in 2021). More Importantly, it was Federal Reserve Vice Chair Richard Clarida who gained market attention this week when he noted that Fed officials may be able to begin discussing the appropriate timing of scaling back their bond-buying program at upcoming policy meetings. *"It may well be*" that "*in upcoming meetings, we'll be at a point where we can begin to discuss scaling back the pace of asset purchase*s," Clarida said Tuesday in a Yahoo!Finance interview. "*I think it's going to depend on the flow of data that we get."*

The majority of central bankers (Richard Clarida included) have thus far stuck to a script that says the recent run higher inflation will be transitory, lasting for few months and then fading. As such, the success of how they manage to unwind the massive easing put in place since March 2020 is vitally dependent on the economic story unfolding in that fashion. "*I do think the Fed will get it right, because they are in line with our view that the upside risk to inflation is transitory*," said Alejandra Grindal, chief international economist at Ned Davis Research (chief international economists are always very convincing, I must admit!). "*We expect tapering to begin in 2022… Then after that we expect to see at earliest a rate*

*increase in 2023, but it could be as late as 2024*," she added (the ability to formulate long term views given current huge market uncertainties, is striking - to say the least).

Economists and most Wall Street strategists have so far embraced the Fed's narrative that inflation pressures that pushed the US Consumer Price Index (CPI) up 4.2% year-on-year in April will subside once supply chain issues and base effects from 2020 wear off. We remain baffled with the market's high confidence in Fed's economic forecasts (given their poor track record), as well as in their future ability to engineer a soft landing from sizable stimulus that saw benchmark borrowing rates taken down to near zero and a nearly $ 4 trillion expansion of the Fed's balance sheet. Surely results weren't good the last time the Fed acted in mid-2013 (or promised to act) and that in turns raises the stakes even more for this summer's communication efforts.

In the meantime. bond vigilantes are acting a lot less vigilant these days! There was a time, following the inflation crisis of the early 1980s, when the bond market, regardless of the Federal Reserve's policy, worked to keep a cap on bond prices (lower prices & higher yields) just to ensure the economy did not get too steamy. Whenever there were signs that the pace of growth and/or inflation was picking up fast, the so-called vigilantes would rush to sell, driving interest rates higher and acting as a brake on the economy. The term was originally coined by former EF Hutton (if this name rings a bell, then you're surely over 45 years old) Edward Yardeni in the early 1980s to describe how bond sell-off could force the hand of central banks or governments. For the past two decades there has been little sign of the vigilantes as inflation remained quiescent globally, and a desperate hunger for returns eroded the discipline of many bond investors. Since the financial crisis in 2008, central banks have also smothered fixed-income markets with a succession of vast quantitative easing programs that neutralized any would-be vigilantes.

But if 2021 is any indication – outside the price action of the past two months - a new era may be upon us! The bond market has witnessed a nice selloff as a result of much improving economic data and the return of substantial budget deficits in the US. The yield on the benchmark 30-year US bond is last at 2.29%, up from the depressed 1.20% level witnessed after the coronavirus outbreak roiled financial markets early last year. Whilst the recent rise in yields has been notable for its speed and power, bond yields remain astonishingly low by historical standards. Low yields in turn have fuelled demand for homes, propping up prices and helping the housing market hold up better than expected amid the economic fallout from the pandemic.

Behind the recent stability in fixed-income prices (April/May period) is a conviction among bond investors and traders that the Federal Reserve would not risk raising the US benchmark interest rate from its current target range near zero too fast (nor too far) until it is confident that growth / inflation are actually showing signs of holding up and the economy is on track to achieve maximum employment and price stability goals (in other words, till infinity and beyond!).

Overall, of course, that is good news for bonds and bondholders (and in turn for equity investors, as economic theory and historical data show that low rates bolster stock prices). But it portends more volatility, and, somewhere down the road, perhaps some brutally painful losses once the fixed-income bubble burst, with 10-year US yields potentially doubling from current levels (1.60% to 3.20%). Additionally, the more bonds central banks continue purchasing, the harder it becomes for them to walk away, particularly with all the fiscal stimulus that is looming in the US. With governments being encouraged to borrow more and central banks set to dominate markets for years to come, many analysts are saying goodbye to bond vigilantes, when it comes to the developed world at least.

*Will coming months prove these analysts wrong and their forecasts inaccurate? I will leave the final word to the remaining authentic bond vigilantes in the market!*

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