Weekly Market Summary

11th of May 2015

The New Market Normal: Surreal Events That Keep Recurring - Fadi Nasser

Back in mid-October 2014, markets witnessed brutal moves in the equity, oil & fixed-income space. For the latter, the 35 bps intraday move in 10-year US Treasury bond yield – down from a 2.21% high early in the morning to a 1.86% intraday low was the largest single-day fall in yields since the Lehman Brothers bankruptcy in September 2008, whilst the magnitude of the intraday decline – adjusted for the current low yields environment – had only been exceeded once in the past half century. As to stocks, those too were all over the place with the Dow Jones Industrial Average falling as much as 460 points at the open on that Wednesday 15th, before paring losses to about 180 points.

Till date, traders remain at loss to explain the October 15th liquidity evaporation and the ensuing Treasury "flash crash". A group of U.S. Treasury market professionals sponsored by the Federal Reserve Bank of New York came to no firm conclusions about what caused the large gyrations in that market on October 15th - according to minutes of the January 28th 2015 FOMC meeting. With no direct evidence for what led the price volatility, I suggested back then to our valuable clients - in a write-up entitled "*Market Investors Seemingly Convinced the Economic Sky is Falling…Should We Be Worried too?*" - a number of critical factors that likely played a role, including depressed Japanese Industrial Production, much weaker-than-expected German and EU ZEW Survey, and more importantly very weak NY Empire Manufacturing Survey, US Retail Sales and Producer Price Index (PPI) - all of which resulted in outright capitulation trading that was magnified by a lessened market broker/dealer's ability or willingness to make markets and warehouse risk in times of stress.

Fast forward to January 15th 2015: In a surprise move that shocked financial markets, the Swiss central bank ended its three-year-old bid to hold down the value of the franc against the euro, abandoning a tool policy makers had said just days before was necessary to ward off deflation. Following the announcement, financial markets were in an uproar: Swiss stocks plunged, whilst the Swiss franc appreciated immediately by 30% against the euro, breaking past parity and trading as low as 0.85 francs per euro. A day before, a negative US Retail Sales print - coupled with sharp drops in oil and copper prices – had resulted in 30-year bond yields falling to a record-low of 2.39%, fueled by market speculation that the global economy may fall into a deflationary spiral and suppress growth. All these enormous market swings were summarized in my economic piece titled *"If You Thought Yesterday Was Crazy, Check Again Your Screens Today !!"*, where I concluded by saying "…What happens next in markets remains anyone's guess ! My crystal ball tells me better be prepared and fully hedged against additional adverse & wild market movements going forward….".

Since then, our warnings to clients have been regularly reiterated. Some of those are reproduced below as a refresher:

Super Mario Draghi Fires a Bazooka…Markets Cheer Up…Who Said Size Doesn't Matter?! – 23/01/2015
Should the aim from recent action be to revive inflation expectations, take long-term rates down close to zero and push equity valuations to new highs (or infinity), the ECB is guaranteed to succeed in the short run. How they later decide to exit those measures (mid-2016 onwards) and keep markets properly functioning remains the big unanswered question?!

FOMC Minutes Show Fearful Fed …… Patience Dragging - 19/02/2015
The last time Janet Yellen warned of asset bubbles (mainly biotech and social media stocks) - aka Fed Greenspan's "Irrational Exuberance" speech on December 5th, 1996 - was back in July 2014. Since then, stocks have rallied another 6%! Maybe, just maybe, the time has come to take away the punchbowl and prevent further bubbles formation.

Bond Trading Just Keep Getting Worst ! – 12/03/2015
It is worth stressing that we have long held a view here that whilst central bankers and market participants claim/ assume that future interest rate normalization will be implemented gradually and "exit strategies" from various QE programs will be smooth –once the economic and financial environment improves – there is a high risk that central banks have become stuck in traps from which it will be difficult to exit without a sharp bond market reaction.

It Is Confirmed…..Central Bankers Have Not Learned a Single Lesson From the 2007/2008 Market Crisis - 17/04/2015
Market developments since the start of the year have been nothing short of spectacular! Oil prices, for instance, were close to 25% lower from the Dec14-end closing levels at one point (late January and mid-March) before recovering fully and setting new highs for 2015 in the past 24 hours. The German stock index ("DAX") was recently up as much as 25.5% YTD (over less than 4 months!!) before retreating 3 percentage points over the last 2 sessions on mounting Greece concerns. And if that was not enough, the average yield on German government debt has now dropped below zero for the first time on record (yields through January 2024 are now below zero, while 10-year German bund yields last trade at +0.06%!), meaning that investors are prepared to accept losses for holding to maturity $ 809 billion of the $ 1.16 trillion total of German bonds in the index!!

And then May 2015 kicked-in!! In what will most likely be remembered as the most epic & fierce fixed-income move in market history (my son will certainly learn about it via a case study at university - 4 years from now - should he opt for a Bachelor degree in Finance!), bond markets across the globe were badly hammered, with German bunds effectively getting destroyed (is there a more sensible word when you realize that the yield on the 10-year Bund moved from 6 bps to 80 bps – a 1233% jump in a matter of 10 days - the biggest and fastest weekly drop in German Bund price history!). Having long been outspoken and unreserved about the increasing involvement (let us simply refer to it as "manipulation") of central bankers and large hedge funds in setting market trends, this week's move came as no real surprise to us, though both its timing and violence remain puzzling given the weakness seen in many of the recently released key US, European and Asian economic indicators (weak US 1Q2015 GDP, Chinese PMI, EU PMIs, German Factory Orders, etc..), not to mention extended monetary accommodation - via Quantitative Easing "QE" - by the European and Japanese central banks (also joined by a chorus of other central bankers on the rate cutting front!).

The "after-the-fact" analysts' explanations for this most recent fixed-income market rout would point to yields beginning their ascent as prominent bond investors - from Jeffrey Gundlach to Bill Gross and Warren Buffet – starts questioning the viability of negative European yields and depressed US yields at a time the European Central Bank's stimulus measures appear to put an end to the risk of deflation, the US Federal Reserve gets closer to raising rates (even Fed Chair Janet Yellen recently joined the chorus, stating that long term US yields are extremely low and will have to rise sharply once the Fed starts raising rates!) and oil prices resume their upward trend. In other words, blaming the selloff purely on technical factors and a crowded long bond trade is a wrong call. "*First fundamentals already suggested that yields were too low, and second we doubt that a huge shortage of German bonds will materialize*", UBS strategists led by Mike Schumacher have said in a market report released on May 6th.

The sheer speed and size of the recent bond selloff (early estimates for bondholder losses are north of US$ 500 billion!!) is worrying to say the least. Should bond weakness soon resume (higher rates and lower prices), one would strongly suspect that the European Central Bank (ECB) President Mario Draghi may have no choice but to step in soon with some verbal intervention and declare that Bund yields - which are now well above where they were trading when QE started in early March - will be pushed lower whatever that takes (A la July 26th, 2012 speech to the Global Investment Conference in London where the same Mario Draghi mentioned that within its mandate, the ECB is ready to do whatever it takes to preserve the euro… And believe me, it will be enough!).

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