Weekly Market Summary

June 25th, 2021

A Fed Meeting to Remember … Surely with a Big Grain of Salt!
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Did the Federal Open Market Committee (FOMC) really meet on June 16th and sound the alarm on higher inflation and interest rates? And wasn't it more sensible for investors to simply take the past week off, before resuming their risk-on trading bets over the last few days?

Last Wednesday, Fed officials gathered and agreed on a notable shift in hawkish direction with regards to the timing of QE tapering and the pace of future interest rate hikes. Even Fed Chair Powell, in a departure from previous communications and personal convictions, speculated that unemployment – not inflation – would be transitory! That was followed by a large drop in equity and gold prices, an immediate strengthening of the US Dollar and the mother of all steepening yield curve unwind trades (an enormous 30 bps flattening of the UST 5-30 years yield spread within 48 hours).

By Friday evening, the Dow Jones Industrial Average (DJIA) had witnessed its worst week since October 2020, with the price drop / market volatility exacerbated by the simultaneous expiration of single-stock options, single-stock futures, stock-index options and stock-index futures (better known as quadruple witching day) and hawkish comments from a typically dovish Fed official (St. Louis Federal Reserve President James Bullard noting late Friday that he thinks the Fed should lift its benchmark interest rate as early as late 2022). At the same time, a sharp move lower in long-dated bonds was pegged to some position unwinding as short-term yields rose and long-term yields fell, helping the Nasdaq Composite perform relatively better (technology and growth stocks' valuations are usually more sensitive to bond yields).

Nonetheless, all market talks about the Fed's super hawkish pivot / surprise made little sense to us and few other market observers. As noted in last week's market update, the Federal Reserve had simply started demonstrating it is now taking note of recent positive economic developments, even though it kept holding on to its "*transitory*" characterization of inflation. Most important, however, is that the Fed had continued to unwisely delay the inflection point for its ultra-loose policy stance, relative to what is needed, failing to take actual and immediate policy actions.

By Monday afternoon, the Fed had released the testimony that Chair Powell intended to give to Congress on Tuesday afternoon (why wait an extra day when the statement tone is very market positive?! 😊) That was immediately perceived as moving the Fed's rhetoric back in a dovish direction, i.e. a central bank less worried about higher inflation and little keen on raising benchmark rates anytime soon. That impression was broadly confirmed when Powell came to answer lawmakers' questions the next day. This time around, the Fed Chair continued to argue that unemployment was transitory, but also stressed that "*we're digging out from a deep hole*" with "*a long way to go*" (sort of "*till infinity and beyond"!* 😊). There might have been an argument for tightening when Powell acknowledged that inflation had increased notably in recent months, though he was quick to point out that it was "*expected to drop back toward our longer-run goal*" as transitory supply effects abate (in other words, come down without great monetary intervention). Late afternoon on Tuesday, all US equity indices were back at or above their opening levels the week before, prior to the Fed meeting announcement (last Wednesday morning levels).

What should we make of this tactical "*turnaround*"? One cynical interpretation, with which we started, is that we could all have taken last week off. Another explanation is to blame the Fed. Powell should have guarded his words more carefully. What were all the Fed governors thinking with their predictions anyway? One explanation is that the dot plot looked more

hawkish than Powell had expected, a confirmation that Fed officials are currently more divided on the future course of economic and monetary policy developments, with the result that his mild rhetoric came across as more hawkish than it would have done against a less scary backdrop; Or it could simply be that Jerome Powell and his colleagues at the Federal Reserve are gauging reactions and opinions, which means trial balloons. Ultimately, the Fed wants to guide a gentle and slow path toward something like normality – even if in the way many short-term traders lose their shirts. Hopefully, nobody got really badly hurt (we will know better next month, when investment banks announce their second quarter trading revenue numbers).

The Fed's shift last week to acknowledge higher inflation and pull forward its rate hike projections is "*a reflection of more positive longer-term dynamics,*" BlackRock Investment Institute strategists led by Jean Boivin wrote in a report. "*We believe the Fed's new outlook will not translate into significantly higher policy rates any time soon. This, combined with the powerful restart, underpins our pro-risk stance.*" Meanwhile, Former Treasury Secretary Lawrence Summers and billionaire investor Ray Dalio continue reiterating their convictions that the U.S. is headed for a period of overheating and inflation that could threaten the economic recovery, even with the Fed signalling it would step in before that happened. Elsewhere, Jeremy Grantham - financial historian and co-founder of the investment firm GMO, as well as a recipient of the Commander of the Most Excellent Order of the British Empire in 2016 for his work on climate change - doesn't hide his feelings towards the Fed and financial markets; Investors are witnessing the "*biggest U.S. fantasy trip of all time in the stock market thanks to a clueless Federal Reserve, speedy stimulus and surprising success with Covid-19 vaccinations."*

Fast forward to today, Friday 25th June 2021 …

A strong sense of calm has now returned to markets, with risk assets continuing their rebound after last week's jittery sessions. This morning, US equity futures are back hovering near records as investors weigh the growth outlook, following a tentative bipartisan agreement on an American infrastructure plan and more reassuring remarks by central bank officials that current faster inflation remains transitory and therefore won't result in a material speed up in policy tightening. In turn, the USD index - which shows its performance against a basket of other currencies - has weakened, the benchmark 10-year US Treasury yield stabilized around the 1.50% mark, whilst gold and bitcoin resume their climb.

The US bipartisan legislation, a $579 billion infrastructure plan that is expected "*to create millions of American jobs and modernize our American infrastructure*" (sounds a lot like Trumps' "America First" message 😊), is expected to move through Congress alongside a separate Democrats-only bill that would spend trillions more on what Biden called "*human infrastructure"* that Republicans oppose. It is not yet assured either measure will get enough wider lawmaker support to clear the House and Senate, given the political splits in the US. as well as differences between progressive and moderate Democrats. House Speaker Nancy Pelosi already noted that her chamber would not consider the bipartisan deal without the broader package of legislation, which Democrats will attempt to pass using the so-called budget reconciliation procedure that avoids a Republican filibuster in the Senate. Similarly, Biden said he would only sign the bipartisan deal if it reaches his desk together with the reconciliation bill.

In other major news, oil is headed this morning for a fifth weekly advance, the longest winning streak since December, as shrinking stockpiles add to signs that global markets are bouncing back from the pandemic. Futures have increased by 2% in New York this week (WTI August futures last at $73.10), whilst global benchmark Brent is at the highest level since October 2018 (last at $74.50). Prices are also drawing support from expectations that the OPEC+ alliance led by Saudi Arabia and Russia - which will meet on July 1st - won't revive production fast enough to prevent markets from tightening. Since Saudi Oil Minister AbdulAziz bin Salman came to office a little less than two years ago, OPEC+ compliance to Saudi-led production cuts has reached an unbelievable 122% after the Covid demand destruction that shortly took US crude to -$40 per barrel on April 20th, 2020. However, with each passing month of oil recovery, the Saudi minister's

challenge to get the Russians as well as legacy cheaters in OPEC to respect the quotas becomes more difficult. Whilst AbS' mantra each time he was previously asked about oil demand was "*I will believe it when I see it*," the Saudi oil minister also knows the danger of allowing the price of oil to continue moving higher fast (hurt the global economy, allow US shale oil production to expand and create major tensions with larger importers such as India and China), That possibly explains his latest views expressed on Wednesday at a conference organized by Bank of America Corp., according to a recording of his remarks obtained by Bloomberg News. "*We have a role in taming and containing inflation, by making sure that this market doesn't get out of hand*," he noted.

For the record, OPEC+ has said it was considering a 500,000 barrels per day hike in its August output, after agreeing to a 440,000-bpd increase in July. But nothing is certain until the group meets on July 1st. It would not be surprising to hear Russia and some others demanding for as much 700,000-800,000 bpd more for August, given that OPEC+ is still withholding 5.8 million barrels daily from the market. The Paris-based International Energy Agency (IEA), which looks after the interest of Western oil importing nations, has urged OPEC+ to start tapping its spare production capacity to bolster supply as demand rebounds. Wall Street trading behemoth Goldman Sachs estimates the oil market is running a deficit of 3 million barrels a day and has predicted a Brent price of $80 before July - a prophecy that looks likely to happen. Not to be outdone, Bank of America has forecast $100 a barrel!

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