As Good as It Can Get?

The global rally in stocks, which began in earnest March of last year, once investors began to surmise that even a global pandemic would not represent the end of the world as we all have come to know it, continued, apace in the second quarter of this year. Stock markets around the world have set records and some interest rates have set all-time lows, in turn sending their prices to highs. Most central bankers around the world seem altogether unconcerned with even discussing tightening monetary policy. And governments around the world continue to shore up dovish monetary policies with expansionary fiscal policies. There just does not seem to be a problem on the horizon. Unless one considers the delta variant of COVID-19, which is more likely to be transmitted from person to person and more likely to make a person sick than the original version. The virus is spreading fastest in places where people are not vaccinated, whether because they cannot get access to one or they choose not to be.

There might be cause for concern that interest rates particularly in the US do not appear to have received the all-clear memo. Basically, in the beginning of 2020 bond market participants were cruising along with a US Treasury 10-year yield between 1½-2%, then suddenly, the Coronavirus shut the global economy completely down and the 10-year yield went all the way down to 50 basis points! Later, at the beginning of November of last year, there was the announcement of the discovery of the first of what would become several vaccines and the world (and markets) begin to think about re-opening. That sentiment sent 10-year Treasury yields back up to 1½%, and the market thought the US Treasury 10-year yield was on the way to 2%. Only by the end of the last month the 10-year yield went down close to 1¼! How did that happen?

That happened because even though stock markets are setting records, investors find themselves witnessing a battle between two opposing forces: one side believes the rally in bond market prices (which is driving yields lower) has gone too far and does not reflect the fundamental strength of the global economic outlook. Supporting this school is the record number of job openings as business executives have turned positive because they see demand returning, the global vaccination campaign continues apace and there is an unprecedented amount of stimulus which is (still) being fed to the global economy.

On the other side are skeptics who assert that the newest variant of the COVID threatens to derail the global reopening, and that while consumers have acted upon their pent-up demand, the rate of that demand growth is slowing. China's growth may have peaked already. They cut bank reserve requirements in the second week of July. GDP prints there have fallen from above 18% earlier this year down to less than half that now. The ISM Services survey in the US fell from 64 to 60 (which is still high) but it had been expected to print at 63.5. So which side is right? Is the world going to

continue to see the re-opening trade dominate, or is there trouble on the horizon? That question will have investors buying and selling for a while, and that should increase volatility for sure.

In other news, OPEC+ met at the beginning of July and was at first unable to come to an agreement to increase the amount of oil they produce as global demand starts to come back online. An unusually nasty, public almost personal spat broke out between representatives of Saudi Arabia and the UAE. One characterization was that the UAE is behaving as though they know the global market is past peak oil and they are taking a game-theory approach to try and sell as much oil as they can as quickly as they can before the time for selling oil is up. Investors did not know what to make of this problem. Almost at once prices for brent crude went in opposite directions. One thing is clear, though, if the OPEC+ agreement had not been extended that would have represented an open invitation to overproduce. Calmer heads prevailed and the issue was resolved by mid-July. This exercise contained a very important message for oil producers: the true purpose of a cartel, any cartel is always and only to act in the cartel's best interest!

As if there were not enough problems on the horizon, investors are trying to game out what the outcome might be for Alibaba, Tencent and many of China's biggest and best tech companies. These companies have run afoul of the Chinese government and their regulators. The government wants to rein in the companies as well as their leaders and in some instances, it may even be somewhat personal. This may remind the US market followers of what regulators are threatening some of the US's biggest and most powerful tech companies with. Most members of the FAANG (Facebook, Amazon, Apple, Netflix & Google) cohort have encountered the attention of their regulators. Things in the US do not appear to have gone as far or done the market damage as is the case in China, but sadly there is still time for that to happen.

The world seems fraught with worries and what appear to be causes for even further worries, and yet stocks seem to be climbing that wall of worries to higher and higher records. Can this possibly continue or is a reckoning imminent? Surely more volatility should be expected. What are the keys to follow in order to try and figure out or even possibly anticipate where markets are headed? One clarion call is that with US Treasury rates around 1¼-1½ and inflation above the Fed's target of 2%, that implies negative real interest rates, and no investor can afford to ignore as strong a market signal as deeply negative real yields, at least not for very long. So, keep an eye on US Treasury yields, inflation, volatility, commodity prices, the election in Germany, and then check back here in three months.