FINANCIAL MARKETS, AN ANTIDOTE FOR UTOPIA

Utopia, a word coined by Sir Thomas More as the title for his sixteenth century book, is an ideal world where everything is perfect, citizens live in bliss and there is no room for conflict. While the world we live in today is far removed from such idealistic conditions, an all perfect place can have unintended consequences for its inhabitants: ennui or boredom. Imagine if every day was like the previous day, and the future is expected to be a repeat of the past. Perhaps, if financial markets were permitted in utopia, the markets can break its monotony, and give its denizens the much needed spice in their otherwise humdrum existence.

THE RETURN OF VOLATILITY TO FINANCIAL MARKETS

The financial markets would not have lived up to such expectations in the year 2017, with its lack of volatility. To its credit, the markets more than made up for this in 2018, with volatility back with a bang. The Dow Jones Index, cheered on by President Trump and windfall corporate profits from the Tax Cuts and Jobs Act, reached a peak of 26951. Solid growth figures, benign inflation and falling unemployment underpinned the performance of the equity markets. But then, to use a cliché from the financial markets, the Fed stepped in to "take away the punch bowl", before the party turned too boisterous. The Fed's rate hikes, and more significantly its phased unwinding of its USD 4.5 trillion balance sheet built to counter the Great Recession, along with the self-confessed "tariff man" Trump's trade war against China, pulled the Dow down all the way to 21,712. The R word (for recession) was mentioned frequently by the market pundits as higher interest rates could be a dampener for growth in the economy. The flattening yield curve, on the verge of inversion, was another ominous sign for the economy and equities.

Trump, who had tied his fortunes to the stock market, and having taken credit for the upside since his election, was furious with the Fed, blaming it for the fall in the markets and for a potential recession. Talk of neighbour's envy or in this case a successor's gloom: in one of his tweets, Trump bitterly pointed out how Obama benefited from "zero interest rates", and that despite the Fed's rate increases, the US economy was still doing well under Trump's administration. There was incessant pressure from Trump on the Fed, to reduce rates.

WHEN THE FED CAPITULATED

At first, Jerome Powell, the Fed's Chairman and a Trump appointee, did not budge, maintaining that the Fed's decisions were not influenced by political considerations. Rumours of Powell being fired made the rounds. Market pundits also chipped in, that the Fed needs to "listen to the markets". Trump's relentless tirade against the Fed on twitter and its Chairman Powell, accompanied by a collapse in the Dow Jones Index in a howl of protest against a tight monetary policy, ultimately broke the back of the Fed. In a move reminiscent of the "Greenspan put", Powell abjectly surrendered, walking back from the talk of continued tightening, by agreeing to "be patient and flexible, and be sensitive to downside risks in the markets". More significantly, he indicated flexibility on the Fed's plans to wind down quantitative easing (QE). The equity markets rejoiced with the Dow immediately up by about 1000 points. As always, it was the Fed talk that moved the markets and not any actual announcement of monetary policy by the FOMC.

OIL, ON A WILD RIDE

The most watched commodity in the financial markets, oil, was also on a roller coaster ride along with equities. Starting the year at USD 66.6, Brent prices went up all the way to USD 86 on talks of sanctions on Iran, an oil exporter. The OPEC oil cartel apart, the three influential personalities behind oil price swings, Donald Trump of the US, Vladimir Putin of Russia and Crown Prince MBS of Saudi Arabia, had different agendas. Putin's Russia, a non OPEC member, having learnt from the lessons from the past, on the risk of excessive dependence on oil and its wild price gyrations, continued to pump oil at its own pace. Saudi Arabia was caught between its economy's dependence on high oil prices and its hesitation to offend Trump, a vocal advocate of low oil prices. The Khashoggi affair had also put MBS on the defensive.

Sanctions on Iran were supposed to take out a significant chunk of oil supplies off the markets. Hence Saudi Arabia, urged on by Trump, stepped up production to make up for the impending shortfall. Then, in a surprise move, Trump exempted several large oil importing countries like India, from the sanctions, for 180 days, bringing Iranian oil back into the markets. By then, Saudi crude supplies had already been ramped up, to make up for the "Iran sanctions", leading to significant over supply. Trump, with this apparent sleight of hand, played a decisive role in pulling down oil prices, with a near collapse of about 40 % from its peak in 2018. Perennially current account deficit economies like India, with huge oil imports, have much to thank for, in Trump.

US shale oil production, has made the country the largest oil producer in the world, with inventory levels at the massive oil storage hub in Cushing, Oklahoma a key metric watched by financial markets. US monetary policy also impacts commodity prices, with an accommodative stance being a positive factor. Oil price movements and US stock indices in late 2018/early 2019, now closely track the progress of the US China trade negotiations.

CURRENCY MARKETS AND CORRELATION

The currency market with about USD 5 trillion a day in volumes, is the largest segment of the financial markets. 2018 was an interesting year for this market too. The Pound Sterling, fell sharply against major currencies, when the Brexit withdrawal agreement was voted down by the UK lawmakers. The Sterling's fortunes are now closely tied to progress on reaching a consensus for an orderly exit of UK, from the European Union.

The US Dollar index DXY was up by 4.6% in 2018 helped by a tight monetary policy and strong growth in the US economy. Market watchers have observed a negative correlation between the Dollar index and US equities. One reason is that, a strong dollar makes exports uncompetitive for US multinational companies, dimming their earnings outlook and stock prices. The DXY index measures the Dollar against 6 currencies, Euro (highest 57.6% weight), Pound, Yen, Canadian Dollar, Swiss Franc and Swedish Krona.

The Japanese Yen (JPY) and the Aussie Dollar (AUD) exhibited interesting divergence. The Yen considered a safe haven currency, appreciates against USD when the global equity markets are in a turmoil, Japan being the world's largest creditor to other countries. The US dollar too, as measured by the DXY index, appreciates in the face of risk off scenarios in the financial markets, against the Euro and Sterling, while weakening against JPY. When the markets are back to a "risk on" mode, the Aussie and Canadian Dollar (CAD) benefit. The Australian economy with its dependence on commodity exports saw its currency move in tandem with US equity markets. CAD too is considered a commodity dependent currency.

In addition, Powell's recent dovish comments on interest rates benefited the Aussie Dollar and other "risky" assets. Any pause by the Fed, is a negative for the US Dollar, while emerging market currencies benefit from a dovish signal on interest rates by the US Fed.

Central bank easing on interest rates, is a negative for the domestic currency in emerging markets. On the other hand, economies like Indonesia and Argentina, in the face of fast depreciating currencies in 2018, resorted to monetary policy tightening with the objective of shoring up their currencies.

In Europe, the Swiss Franc (CHF) is considered a safe haven, with uncertainty in the continent, as for example in Italy, resulting in CHF appreciation.

MORE ON CORRELATION IN FINANCIAL MARKETS

Gold is another important commodity in the financial markets. Being priced in US Dollars, the price of gold moves inversely with that of the Dollar as measured by the Dollar index DXY. Dollar strength as witnessed in 2018, is usually accompanied by a fall in gold prices. Interest rates too have their impact, with Fed talk of easing rates, considered inflationary and therefore a positive for gold price; gold is considered a hedge against inflation. The early 2010's, a period of quantitative easing, saw a rush into gold. Lower interest rates also help in reducing the holding cost of gold, making it more attractive to own. Gold is also considered a safe haven asset, with prices moving up in times of turbulence in the financial markets/weak equity prices. US treasuries too are considered a safe haven asset, benefiting in such a scenario, along with JPY.

Oil prices tend to move in tandem with equity markets, with turmoil in equity markets, instantly reflecting on oil prices, though no inferences on long term correlation can be drawn.

Emerging market currencies like the Rupee, witnessed a sharp depreciation in 2018, thanks to a surge in oil prices, which have an outsized impact on current account deficit and unwinding of QE/higher interest rates by the Fed. Though the Dollar index DXY was up by 4.3% only in 2018, the Rupee fell 9% bringing back memories of the 2013 Ben Bernanke induced taper tantrum. The off shore non deliverable forward markets for emerging market currencies were again spoken of with awe in the financial markets, for their ability to influence prices in the onshore spot markets. Rupee movements of 0.5 to 1% in a day which was unusual earlier, have become a common occurrence.

10 year India benchmark government bond yields beginning the year at 7.33% went up all the way to 8.15%, with RBI's intervention in the FX markets to curb rupee depreciation impacting system liquidity. The central bank brought back liquidity by massive open market operations resulting in bond yields falling to 7.2%, though they have since risen.

WHEN THE CORRELATION IN THE MARKETS BREAKS DOWN

Earlier in this column we recommended that "citizens of utopia" be permitted to dabble in financial markets to break their otherwise monotonous existence. If the stock, money, bond, currency and commodity segments of the markets exhibit a standard pattern of correlation, such behaviour takes away some of the charm of the markets, despite their volatility. It is a generally accepted fact that prices in the equity and bond markets move in opposite directions, with euphoric equity investors moving money out of treasuries, driving down their prices. And when stock prices are down, treasuries outperform. However, in October 2018, there were times when both stocks and bonds moved down together, breaking the past patterns. The other correlations in the various segments of the financial markets, discussed in earlier paragraphs are generic patterns, based on historical trends, which may not necessarily hold true in all future market conditions.

CENTRAL BANKS VERSUS THE GOVERNMENT

Central banks continued to have an outsized influence on the financial markets, through monetary policy, open market operations, day to day liquidity management, and intervention in the foreign exchange markets. 2018 saw tremendous pressure on the central banks on various fronts to cede some of that power to the Governments. India witnessed an outburst from the Deputy Governor warning of the wrath of the markets and “the igniting of economic fire” if the independence of the central bank is compromised. This appeared to work differently in the US, where financial markets set the trend and the central bank followed. A massive sell off in the equity markets caused the Fed to flinch on increasing interest rates, though Trump too contributed by his relentless pressure on the Fed to pause on its plans to hike rates. In all the current tug of war between the governments and the central banks, it is noteworthy that the heads of the central banks are government appointees, who however become inflation hawks the minute they stepped into their new role, ignoring the pleas or tirades from their erstwhile masters. One is reminded of Julius Caesar’s last words to Brutus: “Et tu, Brute?” (You too, Brutus!).

While Powell meekly gave in to political pressure by reinstating the “Greenspan put”, the Governor quietly resigned in India. Subsequently, the central bank tweaked the NPA norms for the MSME segment, while appointing a committee to arrive at the “economic capital” requirement of the RBI. While these moves appear rational, the independence of the central banks is under threat globally. They no longer have the sole monopoly to move markets or set policy. The political class, which has “direct accountability to the people”, now has a very big say on aspects hitherto under the exclusive domain of the central banks.

A final note on who moves the financial markets. Some market watchers attribute the violent December sell off in US stocks to computer driven algorithmic trading. As technology takes over our daily lives, it may also have the last laugh in the central bank versus government tussle.