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The stock market rally continues, with central banks at the wheel

Two sides. Stock markets signal optimism, while bond markets signal pessimism: prices were up again yesterday (due to good data from China), but the global slowdown remains an unknown factor

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Perhaps Francesco Castelli, CFA of Banor Capital, is right when he says that stocks are from Venus and bonds are from Mars. Indeed, the two markets seem to have been speaking different languages for the past few months. The stock market has been on a run since January (including 1st April), making the start of this year the best for global stock exchanges since 2010, and even since 1998 for Wall Street. This is a sign of optimism, of a desire for risk. The bond market is also on a run (although that was not the case yesterday), sending the yield of over 10 thousand billion dollars of government bonds below zero. This, by contrast, is a sign of pessimism. In short, there are two opposing messages. One is reassuring, while the other is disturbing. One is from Mars, the other from Venus.

These two messages, however, are joined by a single explanation: both markets, the stock market and the bond market, have been driven by the gigantic adrenaline rush activated by Central Banks, which completely changed their attitude in 2019 and announced much more accommodating monetary policies than had been expected at the end of 2018. The US Federal Reserve in particular. The progress made in the agreements between the United States and China, which helped the stock exchanges yesterday, is just the sideshow. Central bankers are the real puppeteers. However, one question remains: who should we listen to? The net result of the distortion of central banks, the pessimism of bonds or the optimism of the stock exchanges?

“The change in rhetoric from central banks, especially the Fed, has been consistent from the beginning of 2019,” says Christian Stracke, Pimco Managing Director. “If at the end of 2018 they seemed orthodox and oriented towards a normalisation of monetary policies, now they appear to be more realistic. The market feared that the Fed would continue to raise interest rates, but now it has understood that this will not be the case”. In his opinion, the change in course was true. And this is a widespread opinion. For this reason, the turnaround in the stock market was so sharp. The problem is that this price rally is not dictated by an improvement in the economy, as can be inferred from the bond market, nor from improved corporate profits. The turnaround is largely ‘technical’ in nature, driven by betting on the premise that the time of easy money has not yet ended, unlike it had been feared in 2018.

This creates distortions, facilitated by financial engineering. One of the many examples can be seen on Wall Street. According to Bank of America’s data, among the main buyers of shares on the US Stock Exchange this quarter we find the same listed companies that have made buybacks amounting to 286 billion dollars since the beginning of the year. For the sake of clarity, by taking advantage of low rates and abundant liquidity, US companies create debt by issuing bonds and using a large part of the proceeds not to invest in equipment or research, but in the stock market. In other words, they borrow funds to buy their own shares on Wall Street. This phenomenon has been going on for years. However, it has peaked in an unprecedented manner in the first quarter of 2019. Such phenomenon has indeed been facilitated by the turnaround from central banks, as it lowered rates for companies on the bond market. There are now some companies (for example, French corporations LVMH and Sanofi) that manage to borrow on the market at negative rates.

In truth, a more realistic picture is perhaps painted today by the bond market, which, by contrast, is suffering from greater pessimism. Yesterday, the market remained favourably surprised by China’s PMI (Purchasing Managers Index), which once again indicates economic expansion. However, many indices released recently (and also yesterday in Europe) signal a global economic cooling, so much so that, in the US, the rate curve has been reversed (short-term rates are higher than long-term ones). In the past, this has been a forerunner to recession. Here, therefore, we can see that, if stock markets are on a run largely thanks to monetary ‘adrenaline’ and the fact that in December they had gone down significantly, perhaps bond markets are currently the most useful markets to predict the future. “Looking at the history of the last decades,” notes Francesco Castelli of Banor Capital, “at this point in the economic cycle, we should be paying attention to bonds”.

We shall see if that is the case. What is certain, at any rate, is that the start of 2019 is presenting us with some valuable lessons. One example is the fact that “the economy cannot sustain a real rate increase”, as observed by Alberto Gallo, Algebris portfolio manager. This is because the global economy (starting with the US economy) is too indebted. It is too dependent on hyper-accommodating monetary policies. It is true that, in the absence of inflation, they can continue (indeed, they must continue). However, there is a real risk, according to some, that the whole world may be ‘turning Japanese’.

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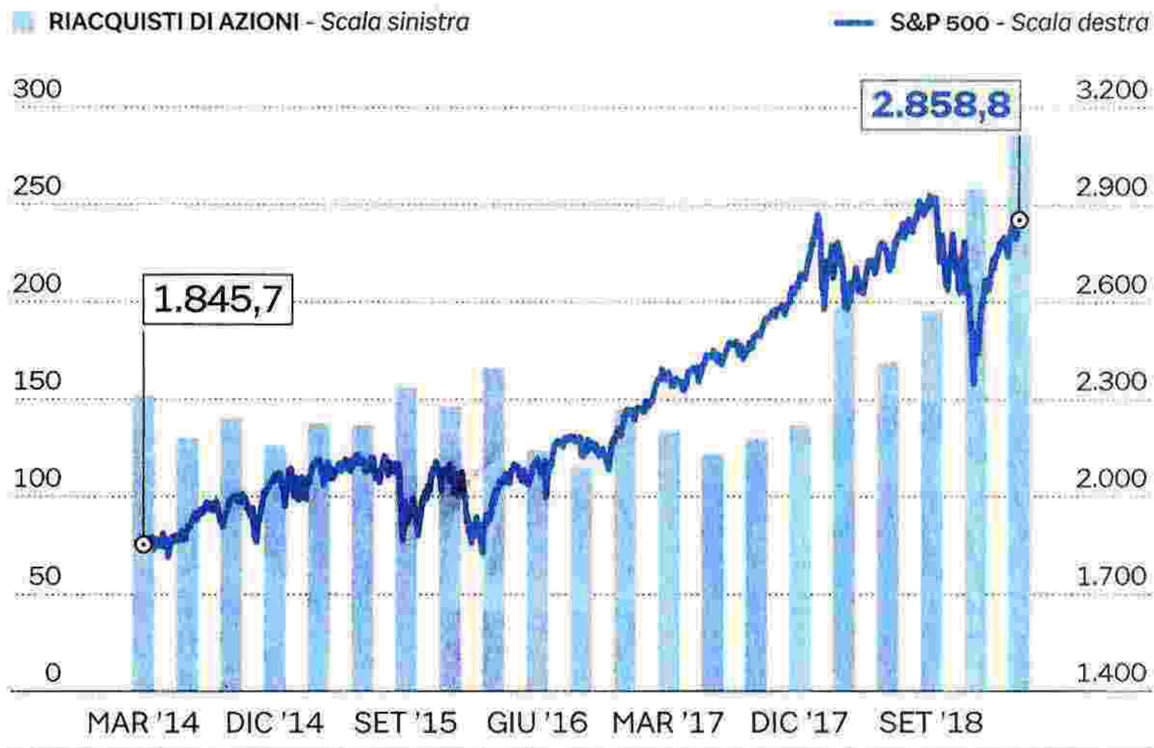
Share buybacks, fuel for Wall Street

Repurchase of own shares by companies listed on Wall Street (quarterly data, in billions of USD), and trend of the S&P 500 stock index



Source: Analysis by *Il Sole 24 Ore* on Bank of America data

RIACQUISTI DI AZIONI - *Scala sinistra*	**REPURCHASES OF SHARES** - *Left scale*
S&P 500 - *Scala destra*	**S&P 500** - *Right scale*
MAR	MAR
DIC	DEC
SET	SEP
GIU	JUN

In the US, listed companies with 286 billion in buybacks were the main buyers of shares

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