MONTHLY MARKET UPDATE: WARNING SIGNS MULTIPLY

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Simon Derrick: Thank you very much indeed.

Hello everybody and welcome to the monthly call. Title of this month's call is warning signs multiply, and I certainly want to get to that in the latter stages of the call but obviously there's been an awful lot happening with regard to Greece and Europe over the last few days and I want to give everybody an update on that before we start. So, there's plenty for us to get through today. So, let me get straight into this.

Five years on from the first Greek crisis it is easy to become a little blasé about the possibility of a default from Athens and even the possibility of an exit from the EUR. However, I think it would be wrong to dismiss the potential importance of the events playing out within Europe this week. Beyond the very direct issues of what that might mean for the people of Greece, and I certainly don't think we should downplay that, it also raises the fundamental question of what the EUR actually is.

I've highlighted over the course of the crisis of the past 5 years, one of the key shifts has been the slow and steady acceptance at an official level that it's actually possible for a nation to leave the single currency. Possibly the most important indication of this came in January of this year when German Chancellor Angela Merkel told Frankfurter Allgemeine Zeitung that she preferred Greece to remain in the Eurozone. By indicating that she preferred Greece to stay in, she also implied that it was also possible for Greece to actually leave the single currency. At that point it became theoretically clear, at least, that the EUR was no longer a single currency with irrevocable membership but with, rather, something closer to a fixed-peg exchange rate system.

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Theory and practice are, of course, two very different things and that's why the events playing out in Greece this week matter for investors. Should a deal fail to result from the current negotiations between Athens and its creditors then it is certainly possible that Greece could end up exiting from the Eurozone. If it were to do so, then investors would know for certain what the EUR actually is. Given that the EUR is the second most widely traded currency in the world, this clearly matters.

So what's the current state of play?

Well it's is clear from recent news reports that the negotiations between Greece and its creditors have become increasingly strained over the course of the past week. Possibly the truest measure of this was the blunt article penned by Prime Minister Alexis Tsipras in Le Monde over the past weekend. Not only did this squarely place the blame for the failure to reach an agreement (at least in the view of Mr Tspiras) on Greece's creditors, it was also a fairly direct attack on the current nature of the Eurozone. Certainly in tone it read less like a plea to Greece's creditors to make one final effort to reach a deal to save Athens from bankruptcy and more like a bitter warning to others.

So what happens next? Well the key issue now, at least in my view, is the time needed to gain approvals from both the Euro Working Group and national parliaments around Europe for any deal that came about in order to ensure disbursement of the delayed aid payments prior to the end of June . And the reason why that matters is that's when the current programme expires, and theoretically, at least the money will be lost. While nothing official has been said, a May 29 Reuters story did made it clear that this Friday is pretty well the last day that a deal can be struck if all those things are going to be managed and Greece is to get the money.

One possibility that had been tabled in recent weeks was that Greece's creditors could present Athens with a simple "take it or leave it" offer this week in order to release the funds it needs to avoid bankruptcy. It now appears that this is exactly what will happen. Following a meeting on Monday evening in Berlin, the European Commission, the European Central Bank and the International Monetary Fund have agreed on the terms of a cash-for-reform deal to be put to Greece. Given that Mr. Tsipras will be in Brussels today for a meeting with Mr. Juncker (and that's scheduled to start at 2030 Central European Time, so that's 7:30 in the evening London time and 2:30 in the afternoon for the east cost of the States), I assume that the proposal to Mr. Tsipras will formally made then. That said, expectations for the outcome of the meeting are already being played down. Mr. Juncker said he does not expect any final outcome from it and Mr. Tsipras said earlier today that he hasn't even seen any comments or documents from the lenders.

The available evidence indicates that there are still likely to be a significant gap between the Greek position and that of its creditors. The FT this morning quoted a person that had been briefed on the creditor's plan as saying that the latest proposals remained "closer to the IMF's stance in several important areas —and that included requiring Greece to keep its pension fund from running a deficit — than the commission's more lenient views." Meanwhile the Greek newspaper Kathimerini quoted sources in Brussels as indicating that Greece's proposal (which was presented on Monday of this week) was too vague and light in detail to form the basis for an agreement. Although, I should point out that some details did emerge about an hour ago. Though it actually is still unclear whether or not any concessions were being made by Athens.

With opposition mounting within Syriza towards any further concessions and the parliamentary spokesman saying this morning that Greece will not make the June IMF payment if there is no prospect of a deal with the nation's lenders, then we need to consider what could happen if no deal is struck.

The first question therefore we need to ask will be whether or not the European Central Bank will threaten to withdraw Emergency Liquidity Assistance from Greek banks. And it's worth noting, by the way, a report that came out on Reuters an hour or so ago saying that the outflows from the Greek Banks reached nearly EUR 1 bn by Friday of last week. The second question will be whether capital controls will be imposed and how quickly.

As I've noted before, the only real model we have is to how events might unfold is what happened in Cyprus following the rejection by its parliament of a EUR 10 bn bailout programme with institutions in March of 2013. That was actually Tuesday March 19th. Reuters actually reported at the time that by the next day there was already "open talk with regards to Cyprus leaving the euro zone" in a call among members of the Euro Group. And 2 days later, the ECB told Cyprus that emergency liquidity assistance to two of the island's largest banks would be cut off if the government failed to agree on a plan by the following Monday. I think most people will remember that by Friday of that week, the Cypriot parliament approved a sweeping bank restructuring package and introduced capital controls that gave the government authority to limit financial transactions in times of crisis. A deal was reached between Cyprus and the "troika" that weekend, although it was described as a fairly stormy meeting. So that's possibly the only real model of how quickly things can happen.

So maybe the other thing we need to consider is what can we say about the response of the market to events in Europe and in particular, what does our own flow data tell us?

Looking through it actually, it presents an interesting story. The introduction of the negative deposit rate last summer by the ECB certainly coincided with a tailing off in demand for debt in quite a number of markets including Finland, France, Germany, Ireland, Italy, Netherlands and Spain. That pattern did begin to change slightly in late 2014 as it became clear that the ECB was getting ready to introduce QE (although the timing remained obviously uncertain until early January). We saw fresh inflows into the markets of Belgium, Ireland and Spain. However, for the majority of countries in the region demand remained pretty modest over the turn of the year.

The announcement of Quantitative Easing (and I would remind everybody it was just a few days before the Greek general election) did spur some fresh demand in late January and early February. France and the Netherlands – certainly we saw sustained inflows for the first time since the summer before. However, other nations didn't experience the pick-up in demand that might, in other circumstances, have been expected from the introduction of a programme of QE. While it's true that fresh inflows emerged into Austria, Finland, Germany and Italy (or did emerge) immediately after the introduction of QE, these have been extremely modest compared to what has been seen before. In other words, the introduction of the asset purchase programme has not been sufficient to entirely overcome the investor disinterest that began to emerge last summer.

Perhaps the most interesting picture to emerge from our flow data, however, is that for Portugal where no fresh demand has emerged at all this year. Now we've got elections coming up in

October (the Socialists appear to have a narrow lead in the polls right now) and (as The Daily Telegraph has highlighted) Portugal has combined public and private debt of more than 370% of GDP right now, so it looks as if the ECB backed programme has not been sufficient to revive international investor confidence in Portugal in the face of those issues.

That said, I think it is important to place this muted interest (or this apparent muted interest) in European bonds in the appropriate context. In particular, it is worth noting that the pattern of interest seen in the first half of this year stands in very marked contrast to the contagion that was apparent in a wide range of markets in early 2012 (prior to Mr. Draghi's famous "whatever it takes" speech). And I think it’s also apparent from the price action in recent months that that’s been the case. While it is certainly true that Portuguese, Spanish and Italian sovereign yields have widened out against their German equivalents (at least until a day or so ago) since mid-March it is also noticeable that they remain at very modest levels when compared to what we saw back in the second half 2011 and first half 2012. In other words, if one of the aims of the ECB when it introduced its Quantitative Easing programme in January was to provide a fiscal firewall around Greece, then I think the evidence so far is that it is actually working.

However, this does raise an important question. If events in Greece are not the dominant factor for the currency markets right now, then what is? And I think the answer really is fairly straight forward, and as it’s been for most of this year, it remains the relentless focus on yield.

I think it’s easy enough to understand why that’s the case. While the monetary climate in Western Europe since last summer has presented remarkable funding opportunities (with investors effectively being paid to borrow money), it has also put anybody with a significant cash balance in a difficult position. Choices have basically boiled down to either accepting being actively penalised for remaining in cash or taking an almost non-existent yield for the privilege of lending money to a northern European sovereign, if those investors don’t want to take on significantly more risk (including of course outside the region). Now I think that goes a long way towards explaining why yields at the longer end have started to prove a quite good indicator for currency moves this year, given the dearth of pick up further in.

Again, I think this goes a long way to explaining the EUR's response to the sharp falls in the prices of northern European sovereign debt between mid-April and the mid-May. You’ll remember that we saw a narrowing in the 10-year German/US sovereign yield gap from around 179 bp on April 16th to 151 bp on May 15th, and that matched almost perfectly to the EUR's rally from USD 1.07 to well above USD 1.14. It also helps explain the EUR's sharp declines following the release of comments by ECB Executive Board member, Benoit Coeure, that the bank would "slightly" frontload asset purchases in May and June due to expected low market liquidity in July and August.

So, while the logic behind some of the recent moves in the currency markets (yield pick-up to the exclusion of almost everything else) is easy enough to see, what stands out is the increasing scale of the currency moves being made as a result. I think that is best illustrated by considering the changing trend seen in 30-day historical volatility in EUR/USD. If you look back to last summer this measure of volatility for EUR/USD had reached its lowest level in the history of the single currency, hitting a low of 3.9% at the start of August (and to put that into context, the average since January 1999 has been 11.3%). Since then the trend has been broadly higher, it hit a peak of 18.2% on April 21 (that’s the highest level since April 2009) although it has in fairness pulled back slightly to currently read around about the 14% level. To put that into even greater context, the high seen in April in volatility has only been materially beaten twice over the past 16 years. And that was during the bursting of the dot.com bubble in 2000 and during the height of the financial crisis in late 2008/early 2009. What's also interesting to note is that the only meaningful comparisons to be made in terms of the pace with which volatility has risen over the last nine and a half months is with the post August 2008 financial crisis move (although I should point that that obviously started at a higher level of volatility). And obviously if look back to pre-EUR days then we saw a similar increase in volatility around the time of GBP's exit from the Exchange Rate Mechanism in 1992.

So I think it's clear from that, that it has not been "business as usual" in the EUR/USD market in recent months. In particular, it says that not only is this the very opposite of the normal "carry trade" (which thrives on and encourages low volatility) but, it's also, less than a month ago that we were experiencing conditions in the currency markets that were not far short of what had only been seen during periods of real financial crisis over the last decade and a half.

So, I think it is important to note, however, that curious price activity has also been emerging elsewhere of late. In particular both the commodity markets and in the Chinese stock market, and in fairness, they're sending some quite familiar signals.

Certainly a range of commodity indices and prices (from the Chicago Board of Trade's wheat futures index and the Thomson Reuters copper index through to platinum prices, and the NZ milk powder commodity index) have found themselves under pressure in recent weeks as the combination of a strong USD and anaemic global growth has made itself felt. Those declines, in turn, remind me that some of the earliest warnings signs that something was awry in 2008 came from the commodity markets. Back then whilst gold, oil and even the EUR/dollar held up remarkably well in the first half of 2008 as investors took advantage of a rapidly easing of monetary policy conditions by the FOMC, other markets were coming under growing pressure as the post 2007 global slowdown took hold. US wheat futures fell about 38% in five months, corn futures dropped 9% in just a two week period, soybean futures lost 5% in just a matter of days. And at the same time, and I'm sure a lot of people remember that the Baltic Dry Index came under increasing pressure through the course of early 2008 as the global slowdown in demand made itself felt in the shipping market.

That isn't the only recent echo of price activity from eight years or so ago. And in particular the Shanghai Composite has been sending some very similar signals as well.

Now the causes of last week's 6.5% decline in the Shanghai Composite (which was the 10th largest fall in 15 years) are easy enough to see. After a six month rally fuelled by the Peoples Bank of China's easing of monetary policy, the bank's move last week to drain liquidity (along with reports of requests from the banking regulator for more information from lenders on their stock market exposure) hit the market where it hurt. While I suspect that we have yet to see the peak in this particular trend, (in fact, I think it might go quite a bit further to the other side), what stands out to me is how eerily similar the broad price action since the summer of 2009 has been in the Shanghai Composite with what was seen in the index between the summer of 2001 and late 2007. In particular I note that both time-frames began with a multi-year period of price attrition in the index that was followed by a dizzying rally. The end of that rally in very late 2007, also acted as one of the earliest warnings of what was to come in the summer of 2008.

So is there common theme?

Well, whether it's the impact of rising USD demand on commodity prices, investors in Europe searching for a yield of any kind or an old fashioned stock-market bubble in China, it seems reasonably clear that each of these moves reflects the hypersensitivity of investors right now to even modest shifts in monetary policy expectations. What's worrying about this is that when we look at these moves collectively they each are highly reminiscent of the type of price action seen ahead of past financial crises. Now while I'm certainly not arguing that a fresh crisis is about to emerge (and if there is I can't see where it's coming from), the fact these signals are nonetheless emerging seems to me to at least to be worthy of some note.

And finally...

Given the fact that since the last call that now we've had the UK general election it seems fair to give a quick summary on what's happening there. So with the dust now settling from the General Election I think we can see a little more clearly the key factors that are likely to drive GBP in the months ahead. Probably the most immediate of these (in terms of headlines) is the government's pledge to hold a referendum on UK membership of the European Union. With a debate already building over whether Mr Cameron might bring the proposed date for the referendum forward to next year (thereby giving the prime minister less time to negotiate new terms for the UK with the other members of the EU) and business leaders, at least some business leaders, already making their opinions on the subject known in the media, it seems reasonable to suppose that a certain amount of "Brexit" angst could weigh on GBP over the summer. However, I suspect this will prove to be something of a short term phenomenon. Firstly, I note that the polls published in recent weeks all indicate a reasonably healthy lead for the "stay in" camp. Secondly, it's worth recalling that the Scottish referendum in 2014 only impacted GBP in the immediate run up to the vote despite a tight race through most of the year.

The bill to devolve further powers to Scotland seems likely attract less attention than might previously have been expected. Talk about another Scottish referendum has certainly faded in recent weeks it seems unlikely that it's going to cause more than momentary jitters in the immediate future, given that even the most extreme outcome (a second referendum) would be some years in the future.

So if domestic politics are only likely to play a relatively minor role in GBP's performance through the early summer then what about monetary policy expectations? The publication of the minutes from the latest meeting of the Monetary Policy Committee (showing that Martin Weale and Ian McCafferty of the committee thought the decision to keep rates on hold was finely balanced) certainly saw a minor a minor shift in expectations in the futures market. Overall though, the publication of the latest inflation data (showing that prices actually fell in April) and the renewed downward pressure on commodity prices only helps sustain my view that we are still a long way off a rate hike in the UK. Indeed, given the most recent price action seen in short sterling futures this appears to be an increasingly common view.

Despite these crosswinds though I have to say I remain relatively speaking GBP positive heading into the summer. Although, I certainly don't dismiss the importance of monetary policy expectations or the possibility that political considerations could weigh temporarily, I also suspect that international factors will prove the prime drivers. In particular (and much as happened in 2010) I think the fresh Eurozone uncertainty could leave GBP looking an attractive alternative. Indeed, it could be argued that the only real differences between now and the period immediately after the last election is that GBP is rather more fairly valued today than it was back then. I should point out the GBP index currently stands about 4% or there about above its post "Black Wednesday" average and then of course the Greek crisis is rather more well advanced.

There we go folks. We've covered plenty of ground in the last 25 odd minutes. I hope that was of value to you, as always. Certainly if you have any questions, please feel free to email me. Or if you want to go on our morning briefing list, again just let me know - I will get that organized. But it just remains me to say I hope you have a great month trading ahead.

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