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The Week That Was

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Mary Shelley's *Frankenstein* is a tale about creating life out of death and the complexities that follow. The story's young scientist, Victor Frankenstein, is obsessed with the arcane and unorthodox corners of science. Devastated by his mother's death from scarlet fever, he embarks on a path of learning that culminates with his development of a secret technique to impart life to non-living matter. His experiments evolve from simple animations to his creation of the Monster, which Frankenstein pieces together from random parts.

The moment of animation is a dramatic success, but Frankenstein's dreams of creating "beauty" are dashed as his eight-foot creation is hideous with yellow eyes and translucent skin. Repulsed by his work, Frankenstein flees, leaving the Monster to fend for itself.

Frankenstein falls ill from the experience and after being nursed back to health he returns home to discover his brother has been murdered. His suspicions turn to horror when he sees the Monster at the crime scene. Left to its own volition, the Monster is a destructive force. Frankenstein, unable to control his creation, attempts to appease the Monster by agreeing to create a female companion for it. Premonitions of disaster force Frankenstein to reconsider, setting the Monster on a path of death and destruction.

Shelley's tale of animation, creating life out of death, and ultimately a monster he can't control have a number of eerie parallels to today's capital markets. During the crisis in 2008, the financial authorities created life out of death by animating the capital markets and piecing together firms from the remnants of those that had gone under. Once pieced together the ensuing creation was a "live" market that functioned, but one that seven years later still requires stimulus. Moreover, much like Frankenstein's Monster, the financial markets are proving to be quite difficult for their "creators"--the monetary authorities--to control.

On Wednesday, Federal Reserve Chair Janet Yellen commented that "Equity market valuations at this point generally are quite high," and then noted that "There are potential dangers there." Another potential trouble spot Yellen pointed out was low long-term interest rates, which could spike as the Fed normalizes its policy, causing disruption across the financial system. "When the Fed decides it's time to begin raising rates, these term premiums could move up and we could see a sharp jump in long-term rates. So we're trying to...communicate as clearly about our monetary policy so we don't take markets by surprise," she concluded.

The market's reaction to her comments was swift and extreme, as both global bond and equity markets quickly sold off. Long-term Treasury rates sold off by as much as 8 basis points and equity markets dropped in excess of 1 percent. (Of course, we have seen this behavior before: adverse comments from a central bank official cause the markets to sell off.) Many investors took the view that her comments on fixed income were foreshadowing a more imminent rate hike than previously thought as economists began debating if a June increase was now likely. However, while the immediate reaction was largely expected perhaps more interesting was the "clarification" that followed the next day, which explained how Yellen had been misunderstood.

We are seeing this same circular behavior play out elsewhere across the globe as monetary authorities from Europe and Asia are beginning to come to grips with their distorted creation--the modern-day capital markets. Negative interest rates, quantitative easing, and massive injections of liquidity are all distortive elements that created “life” in 2008, but the implications of just “what” was created are still not fully understood. It appears that just like Dr. Frankenstein the monetary authorities are finally seeing their creation in a clear light and are scared by its behavior.

In looking at the behavior of the fixed-income market, this week’s trading activity largely followed the outlook tied to our technical view. Heading into the week rates had risen fairly aggressively and had reached levels that were registering as “over-bought” on a yield basis. Our long-held expectations for a large move in rates tied to the low levels in realized volatility have come to pass, as 10-year rates have risen by 42 basis points since the middle of April. Yellen’s comments this week pushed levels briefly above 2.25% on 10-year Treasuries--matching March’s year-to-date highs.

Once these levels were reached, the market was primed for a reversal, which began on Thursday because of softer than expected ADP data (169K vs. 200K) and finished with 10-year Treasury rates sitting at 2.12% by Friday mid-day. Friday’s release of April’s payroll data came in at expectations (223k). However, it was the downward revision to the March figure (revised to 85K from 126k) that resonated with the market. The 85,000 level for March is now the weakest print in the data series since June of 2012 and pushed the 3-month average job gain to 191,000.

The 3-month average is significant because the Fed has indicated that readings below 200,000 would likely delay the timing of the first rate hike. The underlying elements of the data continued the mixed trend we’ve seen with recent reports: 400,000 of the jobs created in April were part-time, while full-time jobs decreased by more than 200,000.

As we close the week the interplay between the market and world’s central bankers appears to be indicating that there is a shift in control taking place. It is hard to argue that the policies and stimulus programs dating back to 2008 did not reanimate the mortally wounded capital markets. However, as we look at the markets today we do not have the “beautiful” recovery that they had hoped for and instead are facing an economic version of Frankenstein’s Monster--a beast that requires extreme measures to thrive and seems to live and die by stimulus. Worse yet, with the selling off and the immediate “clarification,” it appears that creation is now controlling the creator.