'The selling is only just starting': Citigroup warns that markets are 'dangerously unsupported' and there's about to be a fallout

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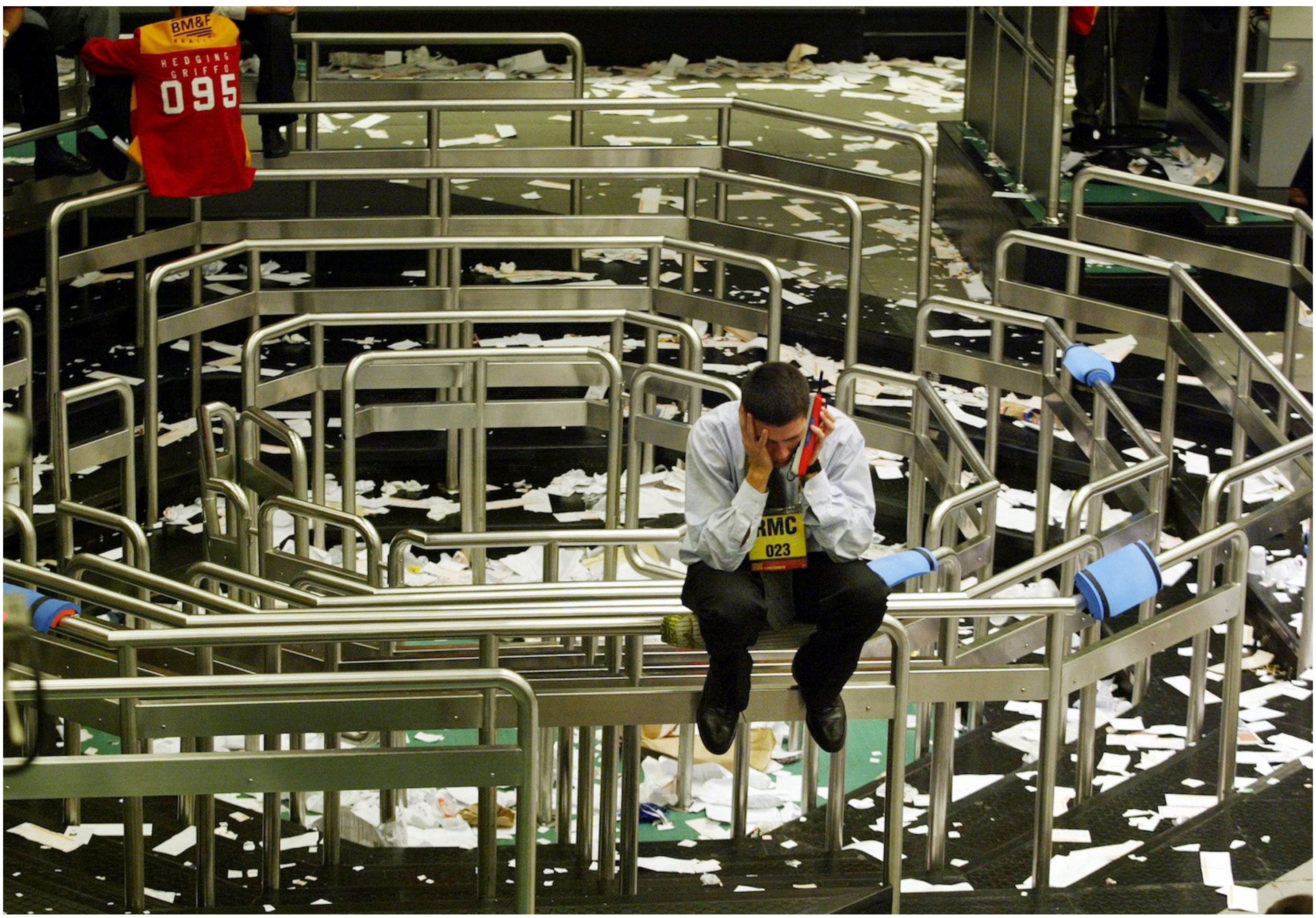
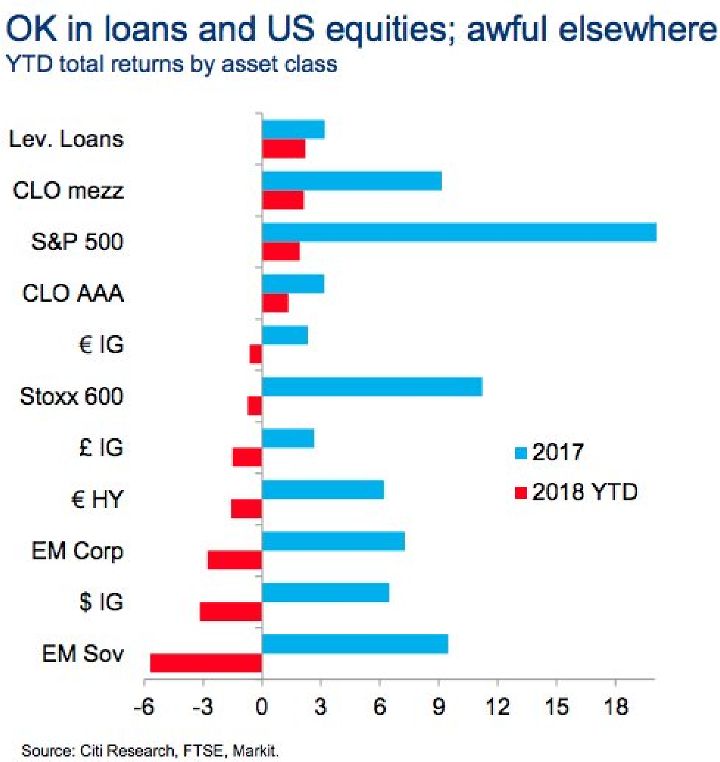


A trader on the floor of the BM&F futures and commodities market in Sao Paulo in 2002.

Paulo Whitaker/Reuters

- **Most asset managers are having a rough 2018, according to Citigroup's well-known credit products strategist Matt King, with many asset classes posting negative returns.**
- **King says that's because there has been less investment from so-called marginal buyers such as central banks and Chinese investors, leaving the market vulnerable.**
- **"Both the world's most important marginal buyers are now in retreat," he wrote. "This leaves risk assets increasingly unsupported."**

It's been a tough year for investors.



US stocks have eked out a positive return this year, but many other asset classes have not, with investment-grade bonds in particular taking a hit.

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There was the biggest Dow point drop of all time back in February. In March, the spread between the dollar London Interbank Offered Rate and the overnight index swap rate widened to levels exceeded only from 2007 to 2009. Then there was political and economic upheaval in Argentina and Italy.

Now the world is facing what China has called "the largest trade war in economic history."

And according to Matt King, Citigroup's credit products strategist, a broader shift is taking place beyond these idiosyncratic events.

Simply put, "the 'wall of money' driving markets has stopped," according to King.

In a note titled "When the marginal buyers go missing," King runs through what happens when so-called off-market buyers make moves in the markets.

According to King's note, the impact of these off-market buyers is such that:

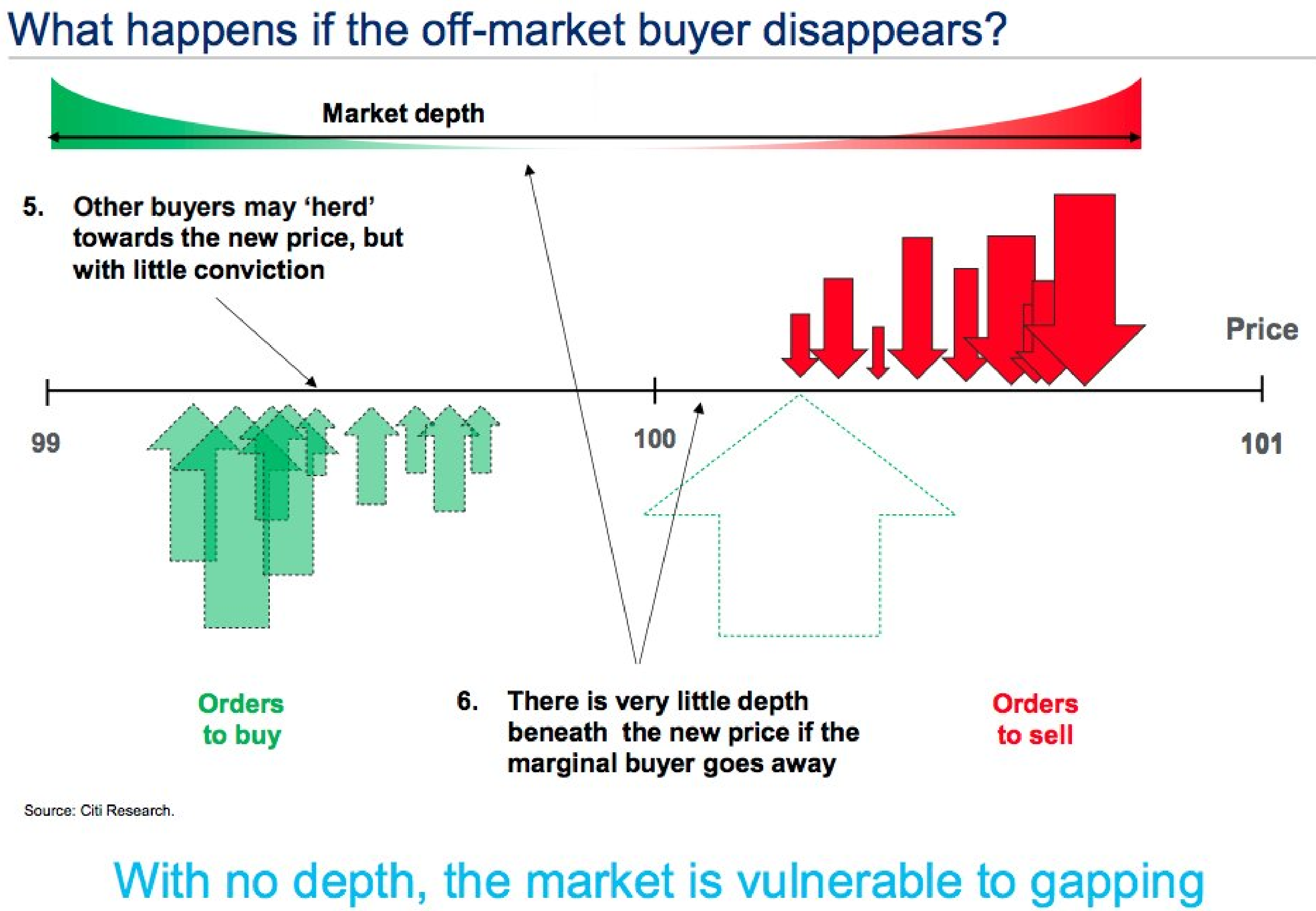
- Price moves up to a new level.
- Trading carries on at the higher price, creating wealth and other broader economic effects.

- Bid-offer and turnover seem normal.
- Volatility is unnaturally suppressed.

In this case, the off-market buyers are the central banks that have pumped liquidity into financial markets in recent years and are now retracing their steps as well as the Chinese investors who have in turn been supported by a wave of liquidity in that country.

"Both the world's most important marginal buyers are now in retreat," King said.

The slide below runs through what happens when these off-market buyers disappear. In simple terms, there's no depth to the market outside the off-market buyer demand, so prices gap lower, and there's little conviction over what represents value in a world that's no longer dominated by these buyers.



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In this scenario, riskier assets like stocks and high-yield bonds are prone to bouts of volatility, and investors look for safety in numbers and herd together.

"The buying has stopped; the selling is only just starting," the note sad.

The note suggests the market now looks as if it's at stage three of the real yield cycle, where "markets get real," with real yields rising, and inflation lower than expected and risk assets negatively affected. The next phase of the cycle, "flight to quality," sees real yields, inflation, *and* risk assets taking a hit.

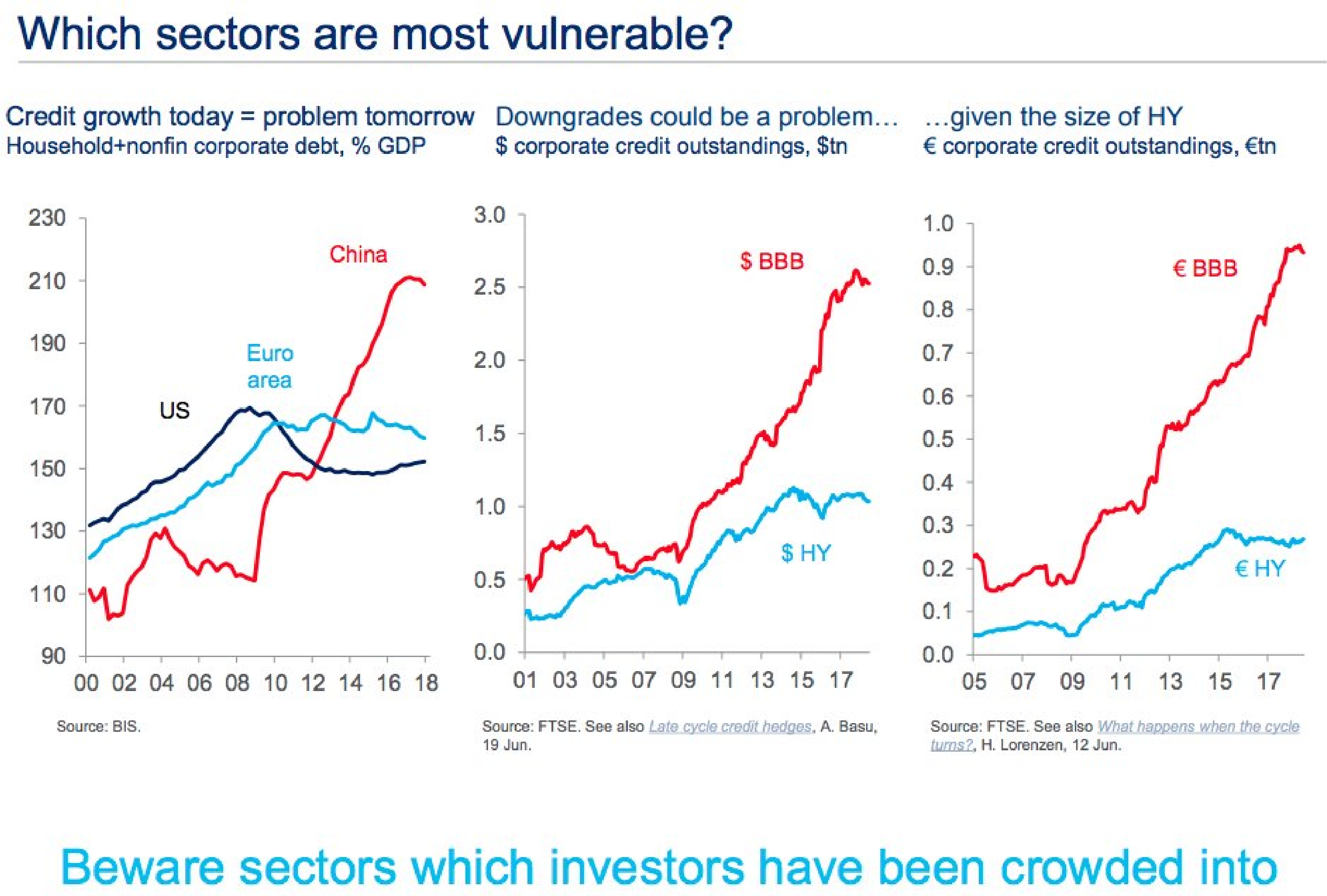
The fifth phase: central banks "to the rescue."

And in a section titled "How to avoid the fallout," the note pinpoints household debt as an issue that could be a "problem tomorrow" and highlights the risk of downgrades in the bond market given the explosion of lower-rated corporate credit that's outstanding.

As my colleague Akin Oyedele recently reported, the Bank for International Settlements, nicknamed the bank for central bankers, has said the ballooning levels of public and private debt are creating a "trap" that would be hard to escape.

King's note concludes:

- "Shocks" are neither isolated nor unforeseeable
- The marginal buyers have gone
- This leaves markets dangerously unsupported



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