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Macro Wrap-Up

Markets Get Circular Reference Warning

February 9, 2018 — It would be nice if investors always processed information in a straightforward manner. Can you imagine a market in which the cause of every move was clear and logical? Probably not. There are just too many participants with differing views coming together to set prices. As a result, a big market move will always lead to conflicting narratives. This time, you could find the usual uninformed anecdotal finger-pointing, but if you looked carefully you could also find a few macro stories. Sure, they were confusing and contradictory, but we'll try to put them together into something at least partially coherent.

Last Friday's U.S. employment number seems to have been the catalyst for the sell-off. Job growth was higher than expected, and the unemployment rate was steady at the cycle lows of 4.1%.[1] Investors seemed most focused on average hourly earnings growth (AHE), which until recently had been considered a second tier statistic. One of the great economic mysteries of this expansion has been the relatively slow pace of wage growth. Until recently, some economists had been worried about the sustainability of the expansion because wages were so low. It is a natural concern: if people don't earn a lot, they can't spend a lot. So, it might seem encouraging that we got a rare upward surprise in AHE of 2.9% yoy in Friday's report.[2]

> As it turns out, the only thing worse for markets than low wages is high wages.

Now investors seem to think high wages will cut into profit margins because companies will have to pay their workers more. By this logic, costs will go up, but revenues will not increase by as much – the higher wages won't lead to enough additional spending from the people being paid more. Strong wage numbers may also encourage the Fed to raise rates more quickly. In his Senate confirmation hearing, new Fed Chair Jerome Powell said he thinks slow wage growth reassures the Fed that there is "no sense of an overheating economy."[3,4] If wages pick up, the Fed may feel more urgency. In the Fed's models, inflation is related to wage growth.

So as far as wages go, markets and economists can either focus on their benefits to consumer spending or their costs to companies. Right now, it seems that the cost side is winning out. What this means is that the market is more worried about inflation than deflation. Our year-end Macro Wrap-Up warned that the biggest risk to the current order was an upside surprise in inflation. After the employment number on Friday, it did look like a typical inflation scare: both bonds and stocks were down. But before taking a victory lap, we should point out that during the worst hours of Monday's rout, markets broke from the pure inflation story.[5] Bonds rallied, and more importantly short rates implied reduced odds of a Fed hike.[6] Commodities, which should benefit from higher inflation, didn't move much either. This may have been an indication that a reversal was coming on the following day.[7]

> When thinking about the relationship between the economy and markets in this context, it's easy to get caught in a logical trap.

A strong economy means the Fed is more likely to hike. This means bond yields go up, which increases the cost of the capital for companies and is bad for stocks. Then lower stock prices signal a weaker economy, which is good for bonds. The lower bond yields lower the cost of capital for companies, which is good for stocks. So stocks can rally back, which means bonds have to worry about a stronger economy. And…. it's like the markets are a spreadsheet giving us the "circular reference warning" message. The higher wage number brought fears of both higher inflation and lower profits for companies, which made the whole spreadsheet crash. That's why we got a very sharp move. (This is a metaphor. It was not caused by an actual spreadsheet crashing.) [8]

The recent volatility has led many folks to claim that we are entering a new regime or era or perhaps epoch. Market volatility spiked, which has led to some spectacular, but non-systemic, blow-ups. As a quant shop, we can tell you that there is some serial correlation in volatility, so markets probably won't immediately calm down. But if you look back at recent history, there have been plenty of other similar, if slightly smaller, spikes. This isn't as anomalous as some would have you believe.[9] There hasn't been any real change in policy or the economy. It's not clear that low economic

volatility, which is a likely cause of low market volatility over the past few years, has increased. If the inflation scare does translate into actual inflation, we may see that. It will be important to follow the budget process to see how much government spending is coming. It is also worth following other measures of wages such as the broader Employment Cost Index measure. But for now, the recent volatility seems less like a regime change and more like a warning that markets can have down days. It is also a reminder that those down days can be pretty big. In that sense, this week's move is far more coherent than anyone's half-baked explanation as to why it happened.

What We Are Watching

U.S. CPI (Wednesday)

To the extent there was a fundamental trigger for the volatility seen in global equity markets over the last week, it was likely the larger than expected increase in average hourly earnings in the most recent U.S. employment report. U.S. unemployment has fallen to low levels over the last year, but wage growth and price inflation have thus far remained surprisingly subdued. This has allowed the Fed to take a patient approach to rate hikes despite continued positive news on growth. The employment report for January, however, showed the fastest wage growth in several years at 2.9% YoY.[10] If a tight labor market is finally beginning to generate faster wage growth, a broader upturn in consumer prices may not be too far off, and the Fed could be forced to raise interest rates more rapidly. Given these concerns, market participants are likely to give extra attention to monthly inflation data. If CPI releases suggest that inflation is in fact starting to accelerate, it could continue to fuel expectations for more hawkish monetary policy, which may in turn be a headwind for fixed income and equity markets.

U.S. Retail Sales (Wednesday)

Retail sales growth was quite strong at the end of 2017, as an improving labor market and positive consumer sentiment appear to have boosted spending. January sales numbers, to be published this week, will indicate the degree to which this momentum has carried over into 2018. Holiday spending has increasingly spilled over into January in recent years, suggesting some reason for optimism. However, severe winter storms early in the month may have weighed on sales to some extent. A disappointing reading might lead economists to mark down their forecasts for first quarter growth. A weak start to the year might be problematic for risk sentiment given optimism around growth prospects for 2018.

Japan GDP (Wednesday)

Japanese growth has picked up lately, as domestic firms have boosted capital expenditures and improvement in the global economy has lifted exports. GDP registered a gain of over 2% YoY in the third quarter,[11] an impressive result in light of ongoing declines in Japan's working age population. Strong output growth has pushed unemployment to a multi-decade low, raising hopes for a sustained exit from the country's long battle with deflationary trends in wages and prices. A positive initial estimate of fourth quarter GDP growth would point towards continued improvement in the Japanese economy. This may fuel speculation over an eventual normalization of monetary policy from the Bank of Japan, potentially driving gains in the yen.

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1 Bureau of Labor Statistics.
2 The Bloomberg median consensus estimate was for AHE to rise by 2.6%yoy. (Sources: Bloomberg, Bureau of Labor Statistics).
3 Bloomberg: "Powell is Willing to Search for More Heat in U.S. Labor Market," 11/28/17.
4 The stock sell-off may seem like a rude introduction to the new Fed Chair. Even Alan Greenspan got almost two months before the stock market crashed.
5 Victory laps are fun, but not when the market is down. And also not when you didn't really deserve one either.
6 April 2018 Fed Fund Futures rallied from 98.36 on Friday, February 2 to a high of 98.41 on Monday, February 5, implying reduced market expectations of a rate hike at the Fed's upcoming monetary policy meeting on March 21. As of Wednesday, February 7, this move had largely retraced, with April 2018 Fed Fund Futures closing at 98.37. (Source: Bloomberg).
7 Or it may have been coincidence.
8 As silly as it sounds, that kind of explanation was not too far from what you got from market commentators. We've shared further thoughts on some of the media portrayal in the following piece: https:/www.aqr.com/cliffs-perspective/risk-parity-derangement-syndrome.
9 The commentary seems to be akin to Kent Brockman asking: "Hordes of panicky people seem to be evacuating the town for some unknown reason. Professor, without knowing precisely what the danger is, would you say it's time for our viewers to crack each other's heads open and feast on the goo inside?" The professor responds that they should.
10 Bureau of Labor Statistics.
11 Economic and Social Research Institute Japan.