There’s a lot of academic research about market underreaction to news. Behavioral economists can point to several tendencies, such as anchoring and the disposition effect, to explain why markets don’t always fully incorporate all of the available information into pricing. [1] But to people who watch economic news on a daily basis, it often seems as though markets either overreact or just react in really strange ways to news releases. Take the retail sales data on Tuesday. The headline number was in line with expectations, but stocks and bonds both sold off. [2] This week we’ll take a look at why a seemingly insignificant release was important to market participants (at least for one day) and what that may be telling us.

The research on underreaction doesn’t try to tell us how the market would react to any single number. [3] There is so much noise in markets. For example, let’s say, hypothetically, a giant meteor hit the earth at the same time as a Philadelphia Fed survey release. [4] Just looking at the numbers and the market price might make it appear as though a slight improvement in manufacturing in eastern Pennsylvania had caused an enormous market move. Fortunately, there were no cosmic disasters at 8:30am ET on Tuesday, so it is more likely that the retail sales data was a factor in market moves. [5]

Another difficulty in evaluating market reaction to a number is that it isn’t always clear what market expectations are for any number. There may be differences between the publicly available economists’ forecasts for a number and what market participants actually think it will be. In other words, on Tuesday markets could have been expecting something different from published expectations and were surprised when the release was what it was supposedly expected to be in the first place. Or something like that. It’s probably best to accept that it is almost impossible to know what these so-called actual expectations are, or to spend too much time guessing what they might be. [6]

A look at the details of the retail sales data may give us a little more insight. Fortunately, the Census Bureau gives us a lot to look at. We can see retail sales excluding the more volatile components of autos/gas and what the Bureau ominously calls the “control group,” which takes out food, autos, gas and building materials. [7] The idea behind these other measures is to give a more accurate reading of core retail sales. The problem is that even taking those out, retail sales is still a very volatile number and subject to revisions in the months after the initial release. In some cases those revisions can drive markets more than the new month’s print. That may be what we saw on Tuesday when both March and February numbers were revised up. [8]

Consumption in general has been a big concern among market participants. Because retail sales numbers in the first quarter were not all that great, it seemed that the economy may have been slowing. There was concern in particular about slowing auto sales after a very strong run following the damage done by Hurricane Harvey in Texas last year. [9] This view was partially confirmed by a tepid first quarter GDP number. [10] As we’ve discussed before, over the past several years there have been some weak numbers early in the year that have given way to stronger growth in the spring and summer. [11] It would seem as though there is some structural problem with seasonal adjustments, but it is difficult to pinpoint where it is. [12] The upward revisions to the past few months make the early tepid numbers seem more like a seasonal fluke. [13] The revisions may indicate that wage growth, while maybe a bit disappointing, is strong enough to sustain spending. This bodes well for the next few months. We are starting to see some slow, but steady, upward revisions in economists’ second quarter GDP estimates. [14] One of the biggest concerns about the economy is looking like less of a concern.

The data may also give a vague indication that the tax cuts are finding their way into the economy. The tax cuts raise the stakes for each release, because a weak number looks even worse in the context of stimulus. You can imagine folks saying that if the economy is sputtering even with the benefit of stimulus, it would be very vulnerable when it wears off. Even a moderately strong number can be reassuring in such a time. [15]

With that in mind, it is intuitive that the retail sales data would be bad for bonds. It means that people have less reason to choose safer assets such as government bonds, and also means that the Fed has one fewer reason to be cautious in its tightening cycle. It is not as clear for stocks. A stronger economy should be good for equities in that it can mean better sales and earnings growth. It is possible that equity investors are afraid of the Fed and higher yields in general. Or perhaps they are afraid of the perception that the economy is too...
strong, even if they don’t believe it themselves.

**The numbers are giving us a hint as to how investors are currently viewing the economy.**

There is some fear about future growth and some anxiety about higher interest rates. Markets do seem to be nervous about particularly bad economic outcomes. That may be why there was a relatively big reaction to seemingly unremarkable data. This type of fear is perhaps natural considering how long the expansion has been going and how strong the stock market has been during the expansion. Such behavior could continue until investors become more comfortable with the economy’s trajectory. Until then, it feels like looking at these numbers is like listening to an audio clip and trying to decide whether you’ve heard “Laurel” or “Yanny.” In markets it’s even less clear what you’ve heard on a single data point. And because the audio clip was obviously saying “Laurel.”  

**What We’re Watching**

**FOMC Minutes (Wednesday)** The FOMC left policy unchanged at its May meeting, but the post-meeting statement reiterated that the committee expects “further gradual increases in the federal funds rate.”  

[17] Markets are pricing high odds of a rate hike at the next meeting in June.  

[18] followed by either one or two additional hikes in the remainder of the year (which would bring the total number of 2018 hikes to either three or four). This pricing is consistent with the most recent Summary of Economic Projections (SEP) from March, in which FOMC participants were about evenly split between these two policy paths.  

[19] Market participants will scrutinize this month’s minutes for signs that the balance of opinion on the committee is shifting in one direction or the other. Those in favor of more aggressive tightening will likely emphasize that unemployment has fallen to low levels and inflation has picked up to around the Fed’s target.  

[20] Those arguing for a more gradual pace of hikes may point to the still-limp pickup in wage growth as a sign that the economy is not yet operating at capacity and inflationary pressure remains manageable. The tone of the conversation in these minutes could provide a hint of whether significant changes to the SEP are likely in June.

**Eurozone PMIs (Wednesday)** While U.S. growth numbers have perked up following a bumpy start to 2018, this has been less true in the eurozone. Since the start of the year, both survey and “hard” data releases have indicated a loss of momentum after a very strong 2017.  

[21] The Manufacturing and Services PMIs for May will provide an early indication of whether growth in the common currency area has stabilized or slowed further in recent weeks. The answer to this question could have implications for European Central Bank (ECB) policy. Current ECB guidance calls for continued large-scale asset purchases “until the end of September 2018, or beyond, if necessary.”  

[22] Weaker than expected PMI results could cause market participants to price in greater odds that the purchase program is extended beyond September. Such an outcome would likely support local government bond markets and weigh on the euro exchange rate.

**U.S. Durable Goods Orders (Friday)** Just as the monthly retail sales data plays helps to assess developments in consumer spending, the monthly durable goods report provides a high frequency measurement of trends in business spending on capital equipment. Capex was an area of strength in the U.S. economy in 2017, but indications since the start of the year have suggested a mild slowdown, a surprising development given talk that the tax legislation passed in December might boost investment. If durable goods orders continue to flatten out, it might be a sign that other factors, such as uncertainty around changes in trade policy, may be weighing on capex outlays.

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[1] If you want to find out what their tendencies are, you can read any of the number of pages we’ve written on this, including this.

[2] The headline retail sales number was 0.3% MoM for April, in line with the Bloomberg economist survey median estimate. In the 20 minutes after the retail sales data release, the U.S. 10yr Treasury yield rose 3bps from 3.02% to 3.05% and S&P 500 Index E-mini Futures sold off 0.3%. Source: Bloomberg, Census Bureau.

[3] This isn’t a research piece so it’s okay to do that here.

[4] This hasn’t happened, and we’re not predicting that it will.

[5] Despite what you may have read, negotiations over a new government in Italy are not a cosmic disaster.

[6] Take that extremely muddled strawman!

[7] The Bureau of Economic Analysis uses the retail sales control group data for its GDP consumption data.

[8] The headline retail sales number for March was revised higher to 0.8% MoM vs. 0.6% previously, while February’s data was revised higher to 0.0% MoM from -0.1% MoM previously. Source: Bloomberg, Census Bureau.


[10] The first estimate of Q1 2018 U.S. GDP was 2.3% QoQ, which was tepid relative to more elevated economist expectations earlier in the quarter of 2.7% QoQ (looking at survey expectations on March 14, 2018). Source: Bloomberg, Bureau of Economic Analysis.

The seasonals are usually calculated using a moving average formula, so any bias should work itself out. It's strange that it keeps happening.

We discussed this possibility a few months ago.

The Bloomberg economist survey forecast for the Q2 2018 QoQ GDP rate has moved up from 2.50% on January 1, 2018 to 3.10% as of May 17, 2018. Source: Bloomberg.

This isn't exactly the same as saying folks expected a different number, it's more that they were afraid of a nonlinear reading, even if they agreed with the mean. Of course none of this can be proven, which is why this falls in the category of unscientific observations.

Or "Yanny."

Federal Reserve: “FOMC Statement,” 5/2/18.

Odds derived from market pricing of Federal Funds futures contracts. Source: Bloomberg.


The U.S. U-3 unemployment rate has fallen to 3.9% as of April 2018. The U.S. core PCE has risen to 1.9% as of March 2018, very close to the Fed’s 2% inflation target. Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

The Markit Eurozone Composite PMI has fallen from 58.1 as of December 2017 to 55.1 as of April 2018. The Euro Area GDP growth has slowed from 2.8% YoY as of Q4 2017 to 2.5% YoY as of Q1 2018. Source: Markit, Eurostat.


U.S. durable goods new orders ex-transportation growth has slowed from 9.72% YoY as of December 2017 to 6.50% YoY as of March 2018. Source: U.S. Census Bureau.