Will Powell come to the party

Posted on June 4, 2019

With a small break in the onslaught of bad news on trade barriers and talk of anti-trust investigations, US equities rebound from their recent sharp falls. US yields are also off the deck, but the market is sending out invitations for a rate cut party, and waiting for the Fed to turn-up. Fed Chair gave just enough hint that he might turn up, but he is still reluctant to acknowledge that risks to growth have increased. Lower US yields and hopes of rate cuts have shifted the tone from a strong dollar to a weak dollar, and this may continue for the time being. PMI data for the US from Markit have fallen sharply already pointing to weak US growth, running now below the Eurozone. With some mixed messages from US data, payrolls data on Friday may take on even more significance.

A break in the onslaught

On Tuesday, the equity market recovered some losses after fast pace news developments on trade and anti-trust investigations into the big US tech companies, drove equities down significantly over recent weeks.

US yields rose on Tuesday, but have fallen rapidly in recent weeks. US Fed Dove Bullard said that the Fed should be considering cutting rates on Monday, helping push rates to their lows, and weakening the USD.

On Tuesday, Fed Chair Powell felt compelled to respond to recent market developments and opened his speech on long term policy issues saying:

"I'd like first to say a word about recent developments involving trade negotiations and other matters. We do not know how or when these issues will be resolved. We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective."

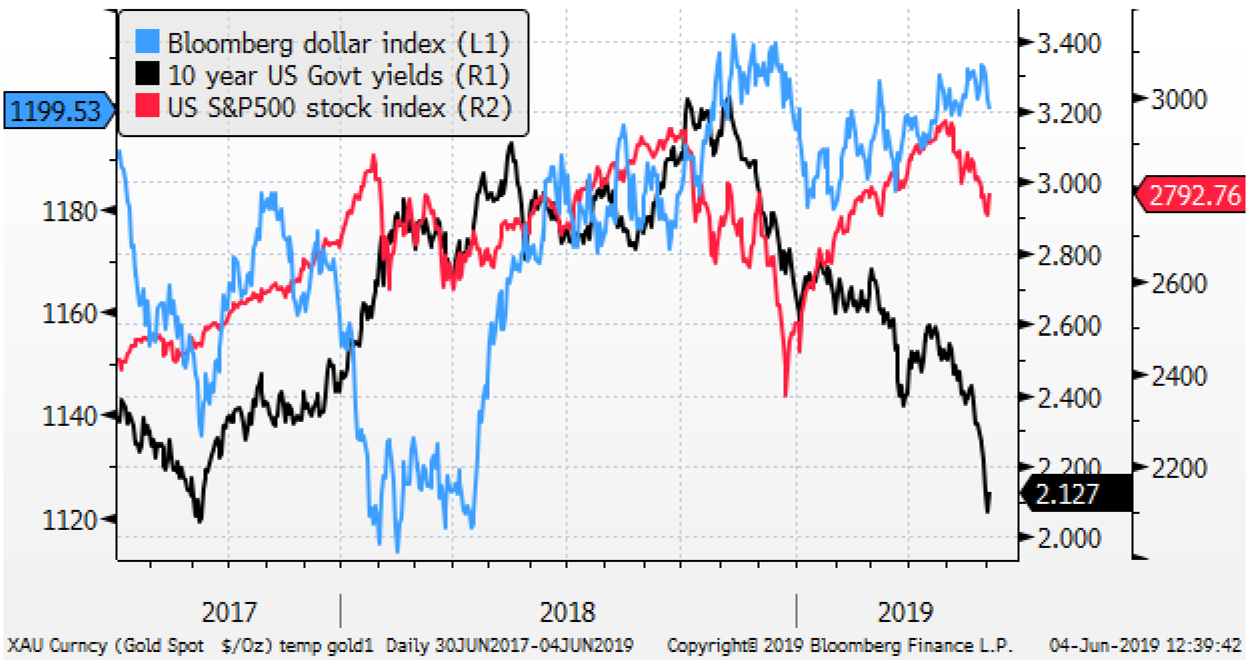
These words appear to suggest the market is not wrong to price in Fed rate cuts on the risk that trade wars lead to a deterioration in the US economic outlook. They provided some impetus for a recovery in the equity market.

The idea of a Fed put, the capacity to ease policy significantly if required, is helping underpin equities, limiting their down-turn on trade war risks. With no further news on the trade front and lower US yields, there is scope for some corrective recovery in equities and other riskier assets.

However, fresh trade barriers have been erected (higher tariffs, entity listings, new war-fronts), anti-trust investigations are underway against big US tech companies, and global manufacturing and trade growth has slowed since last year to a crawl, including in the USA. As such, there should be limits to the rebound in US and global risk assets, and US yields should retain much of their recent falls.

The USD has steadied after its recent fall from relatively high levels, but the risk of lower US rates should keep it down from recent highs, and we still see scope for further declines to catch-up with the significant fall in US yields from their peak last year.

US yields, equities and exchange rate



Will Powell show up to the Party

The comments by Powell help support the notion of a Fed put, but the Fed has displayed inertia since Powell became the Chair, and his comments today fall short of dispelling fears that the Fed might not act swiftly to support the economy if required.

Powell made similar comments as financial market upheaval picked up in October/November last year, and hiked rates in December anyway. The Fed's latest policy message is that it will be "patient". Patience was calming when it meant the Fed might refrain from hiking, but it's disturbing when it delays the Fed from cutting.

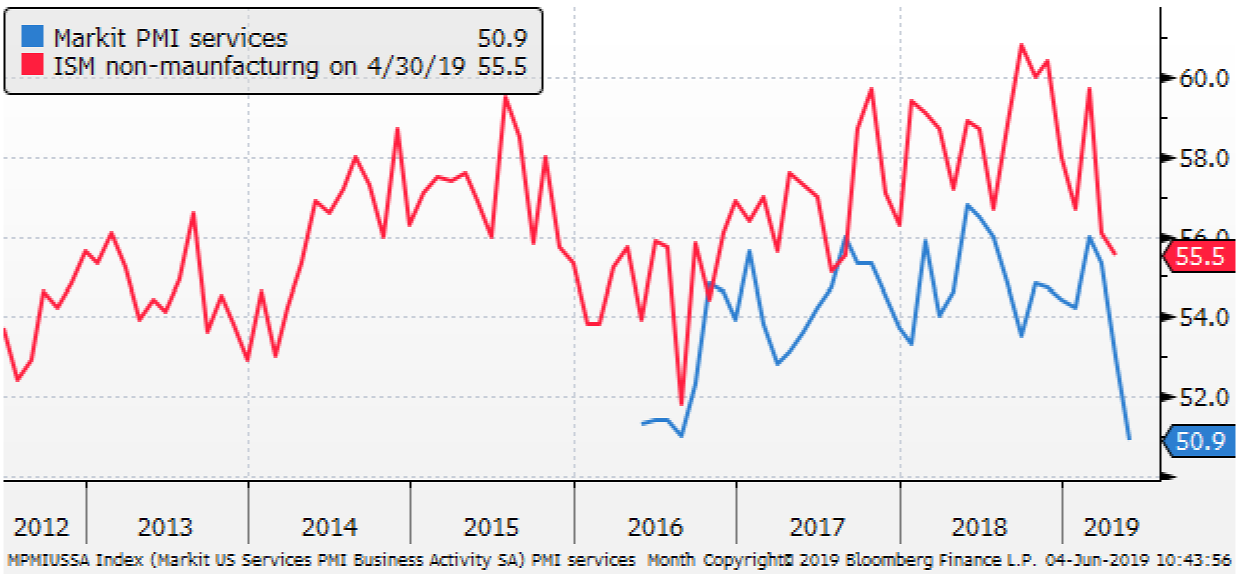
Powell said, "we do not know how these issues [trade policy] will be resolved", suggesting he is still waiting for outcomes, rather than acknowledging that uncertainty has dampening confidence. The risk remains that the Fed will be late to the party when it comes to easing policy.

A surprising drop in Markit PMI measures for the USA

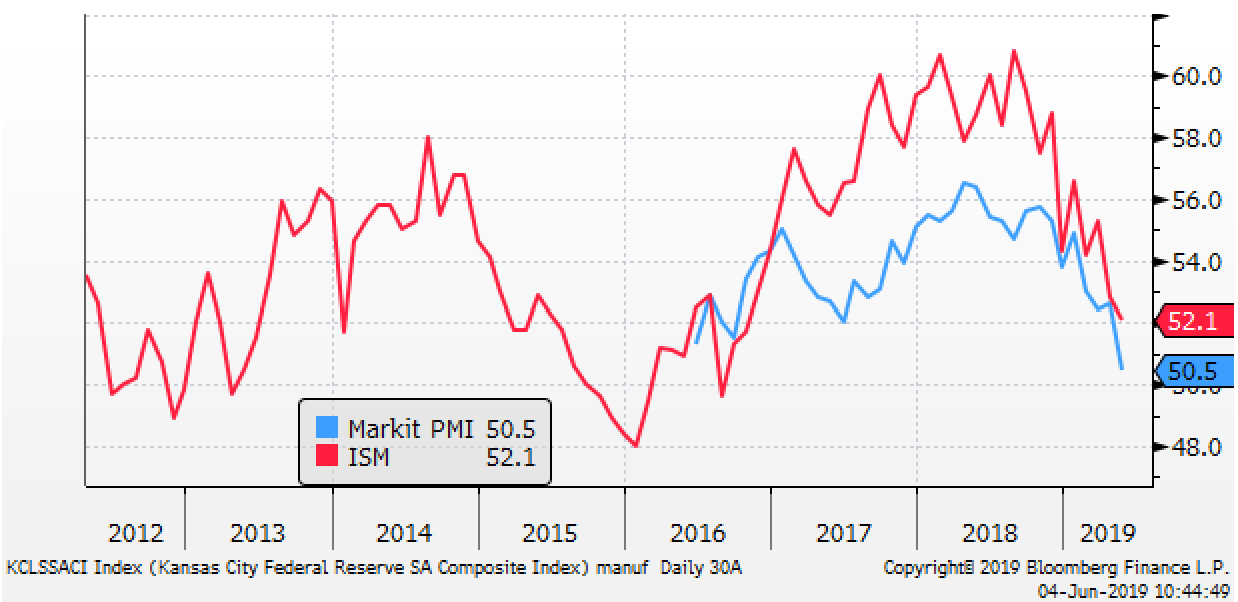
It doesn't appear that the market really believes it, but the recent Markit PMIs for the US economy were surprisingly weak, deteriorating rapidly in recent months; to be barely in growth territory in May.

The ISM manufacturing index has also fallen significantly to 52.1 a low since 2016. The non-manufacturing index is due on Thursday, and the market is expecting little change (55.4, down from 55.5 in April). The Markit PMI for services suggests there is downside risk to this release.

Markit PMI services slumped from 56.0 in Feb to 50.9 in May



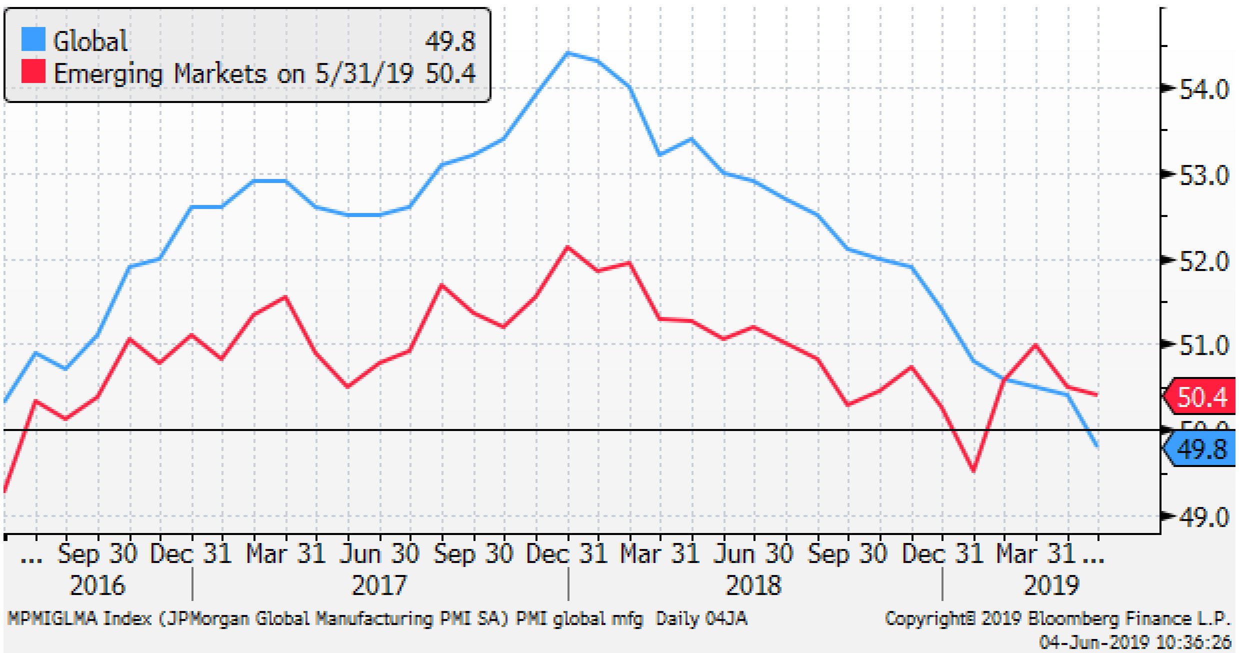
Markit PMI manufacturing fell from above 55 in Nov to 50.5 in May



The weak Markit PMI manufacturing for the USA helped drag down the global measure into net negative growth territory below 50. Whether this is an exaggerated look at the state of the global economy or not, it suggests that trade policy uncertainty is already dragging on the global economy.

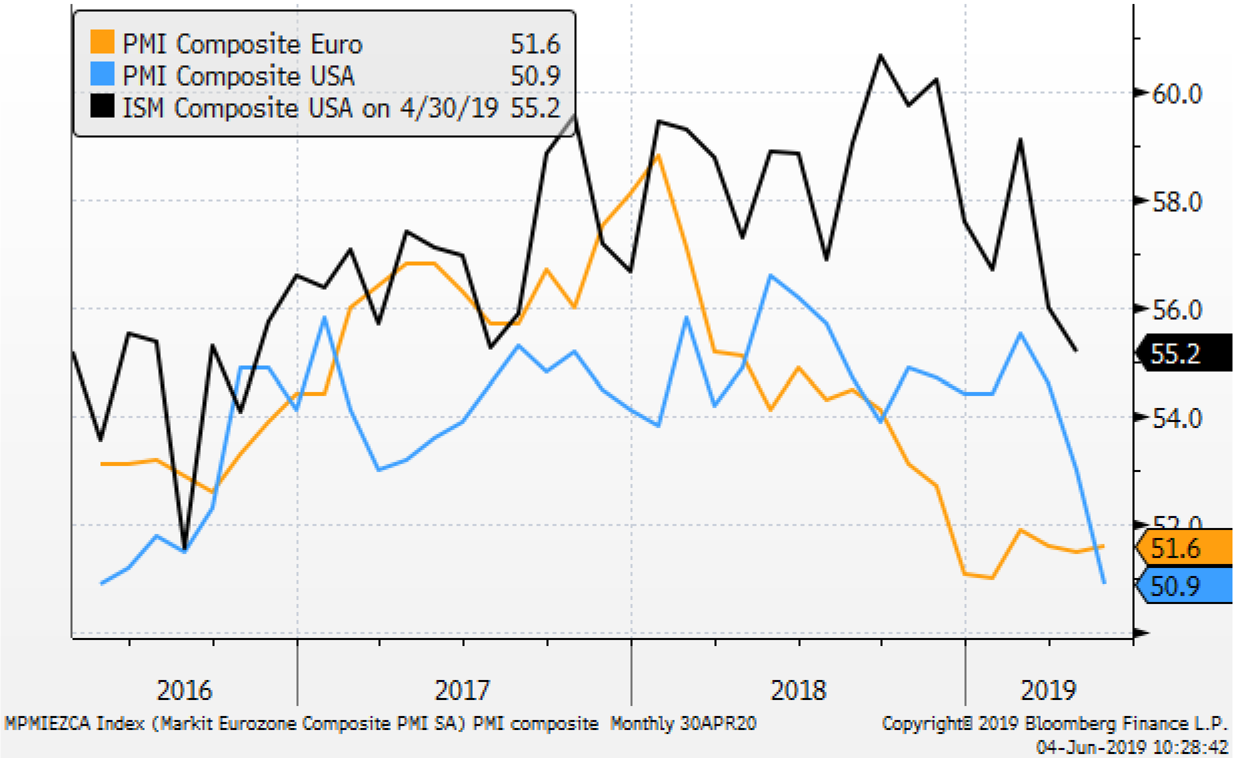
The emerging market PMI has been stronger since a low in January and may suggest the global outlook is not so dire. Perhaps it suggests that some emerging market assets are better placed to perform relative to the US and other major economies.

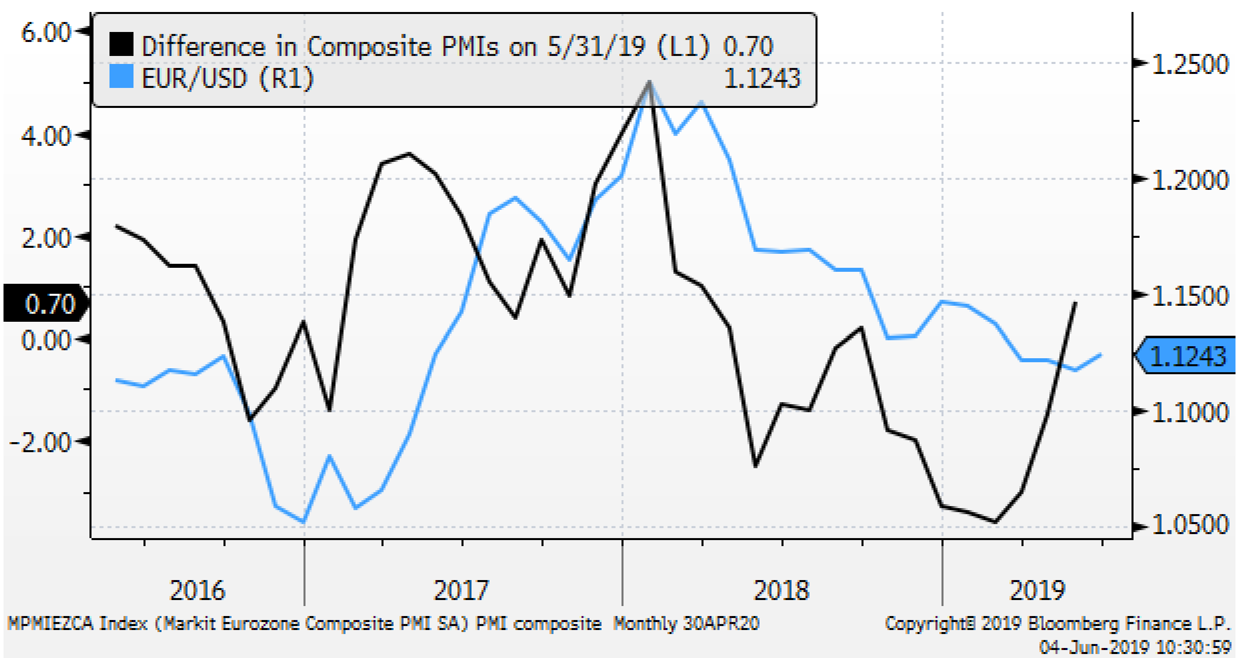
Markit Global manufacturing PMI fell to a low in May since 2016, into negative growth territory sub-50



In light of the considerable deterioration in the outlook for the Eurozone and EUR since last year, on weaker Eurozone manufacturing activity, it is interesting that the Markit PMI composite for the USA has fallen abruptly below that of the Eurozone. This might point to a further recovery in the EUR.

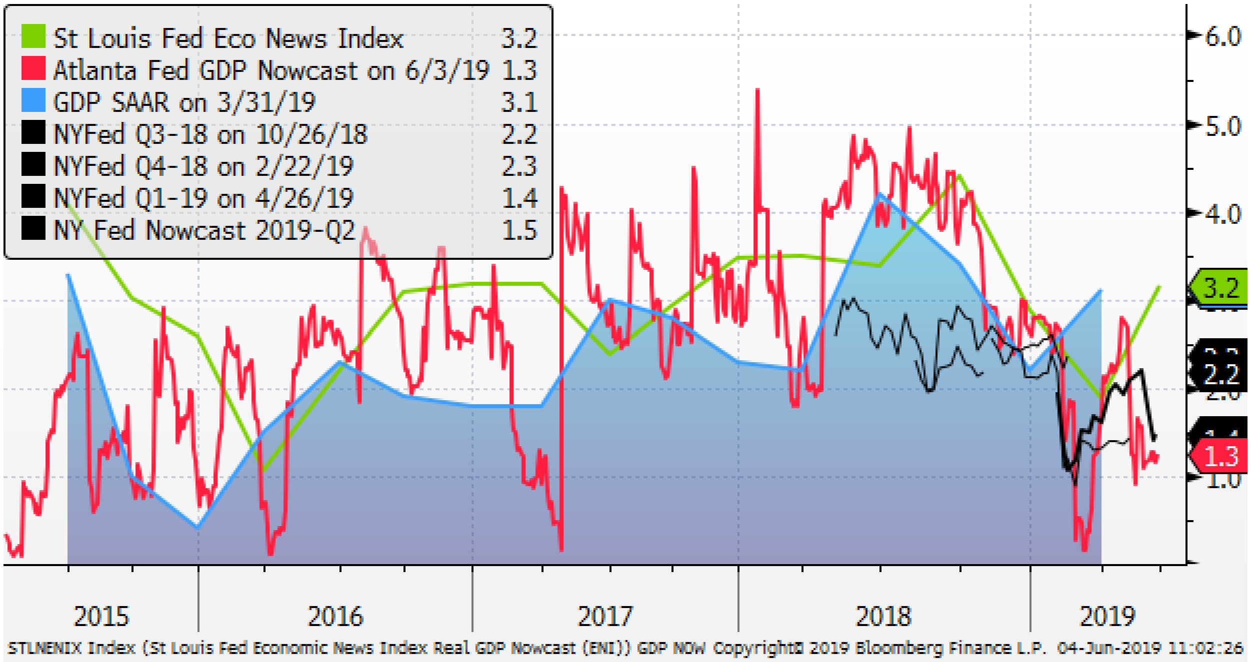
Markit PMI composite – USA fell sharply from 55.5 in Feb to 50.9 in May, below the Eurozone's up from a low 51.0 in Jan to 51.6 in May





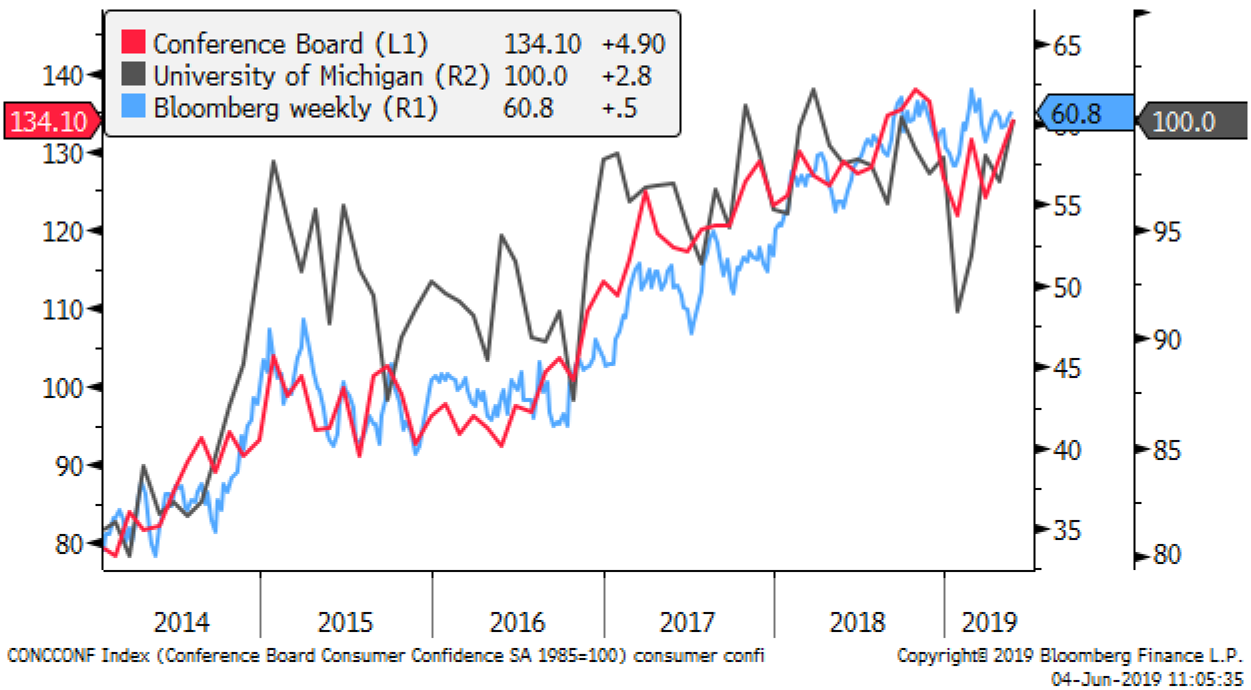
There are mixed measures on the US economy. This is illustrated in the GDPNow forecasts for growth in Q2. The Atlanta and NY Fed models predict weak outcomes (1.3% and 1.5%), while the St Louis Fed index, is forecasting a strong 3.2%.

GDPNowcasts – Alternative Fed estimates of Q2 USA GDP growth based on the currently available monthly data releases. NYFed (1.5%) and Atlanta Fed (1.3%) predict weaker growth, St Loius Fed predicts a strong 3.2%. St Louis Fed appears to give a higher weighting to still strong consumer sentiment

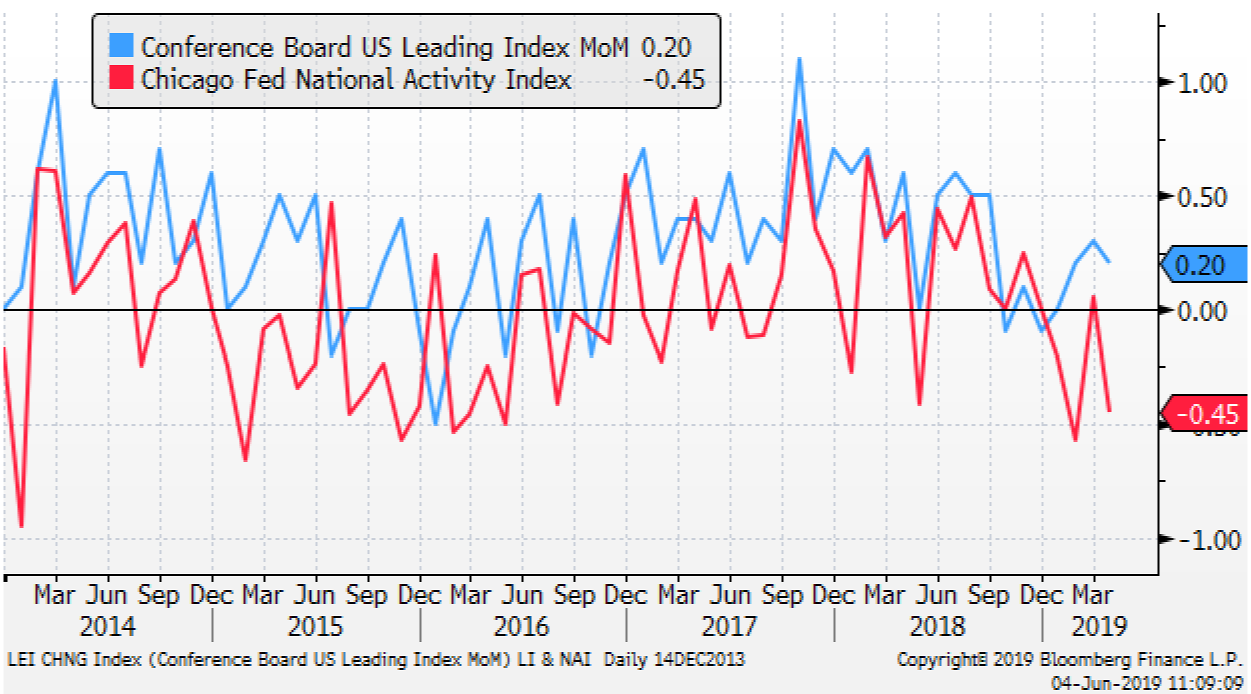


US consumer sentiment readings have remained strong, recovering over recent months, and holding up surprisingly well in May considering the correction in the US stock market. They probably still reflect a relatively solid labour market

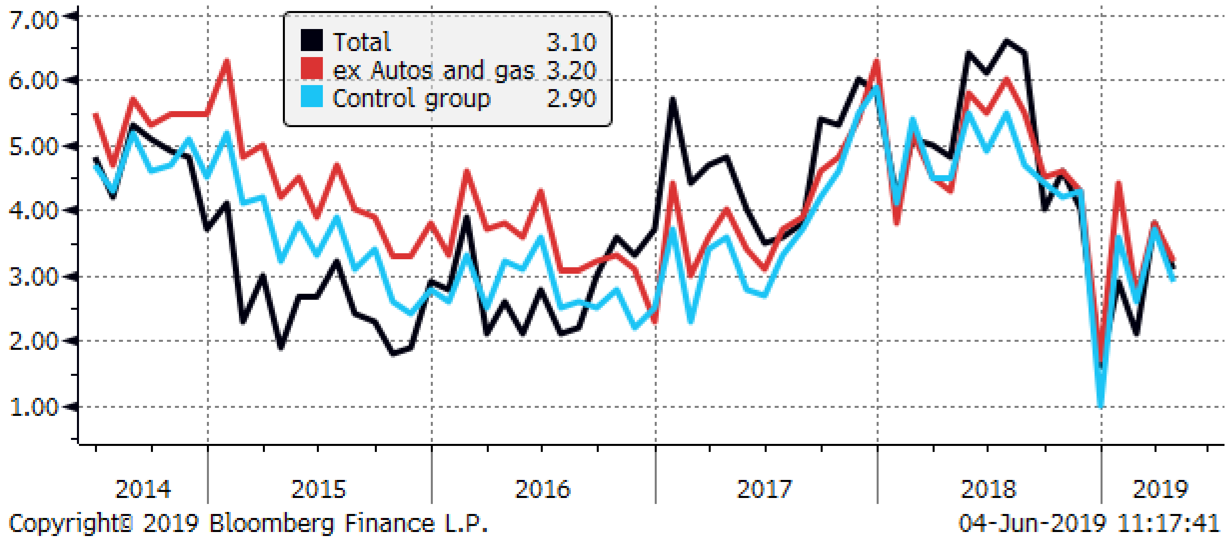
US Consumer sentiment readings relatively strong



Chicago Fed National Activity Index has been mostly negative this year, suggesting the economy has been operating below potential. The Conference Board leading indicators were around zero from Oct-Jan, and have recovered in Feb-Apr to a moderate annual pace of 2.8%



US Retail sales %y/y – sales dropped sharply in December, and have recovered through this year to April, but the annual growth rate remains around the lows since mid-2017



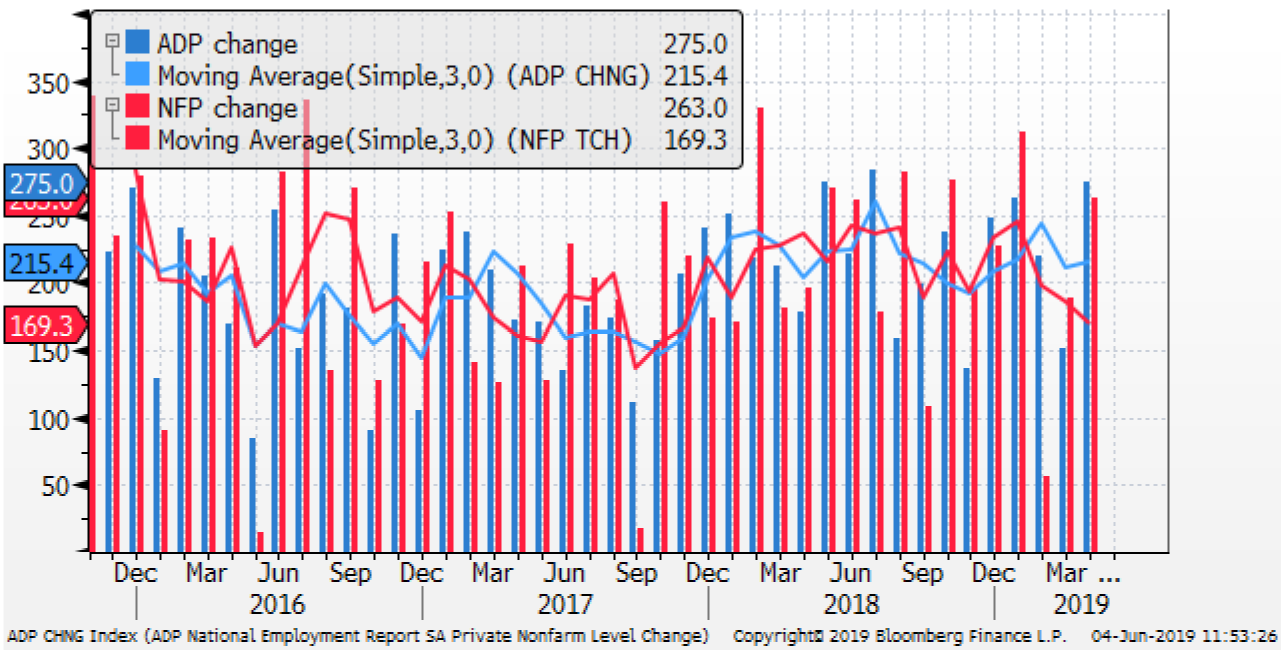
Payrolls the key to near term sentiment

Currency and asset markets may take much from the payrolls data on Friday, which may be viewed as helping settle the mixed messages from weaker PMIs and strong consumer sentiment and recovering retail spending.

Powell and the Fed at least appear more willing to consider cutting rates if the economic data give them enough reason. As such, the payrolls data, both the number of jobs and the unemployment metrics, may have even more impact on near term direction than usual. To date, the labour market data have remained strong, above potential.

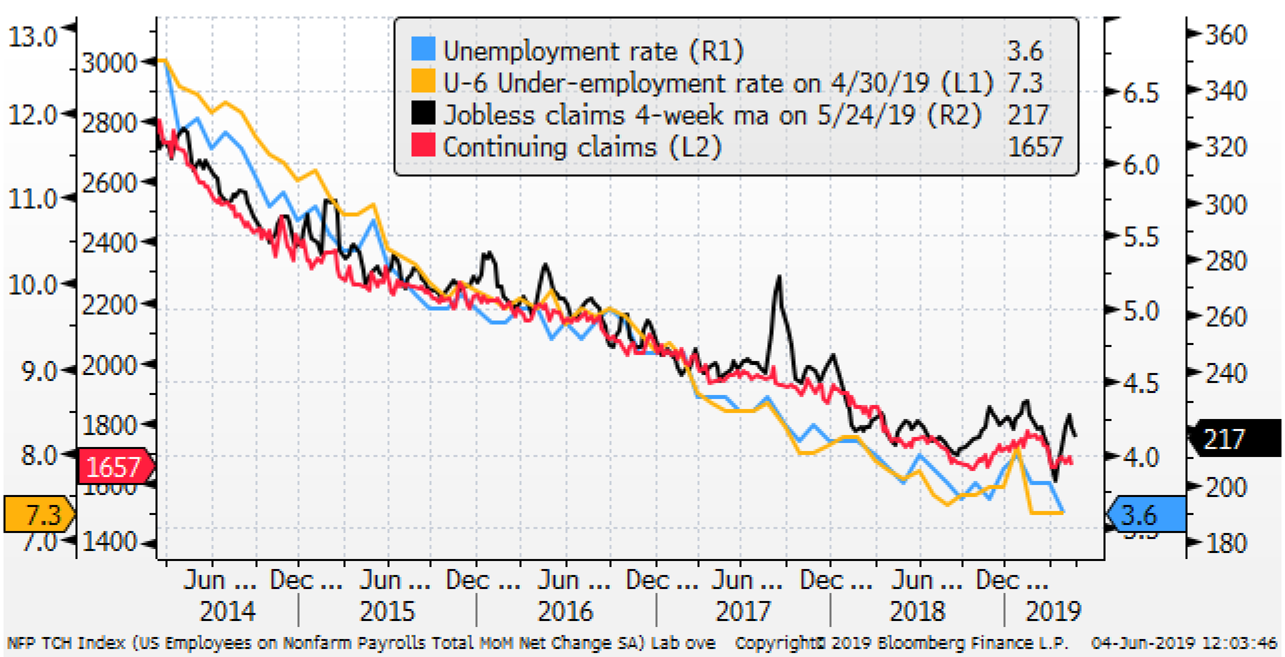
The market will be looking for the ADP report on Wednesday for guidance on Friday payrolls. It has had a checkered history in predicting the outcome. The market is projecting a 180K increase in payrolls, somewhat above the 3mth average (169K), but below the six-month average (207K). Overall there has been little discernible change in the trend in payrolls growth from a strong above-potential pace over the last year.

USA payrolls – govt and ADP series

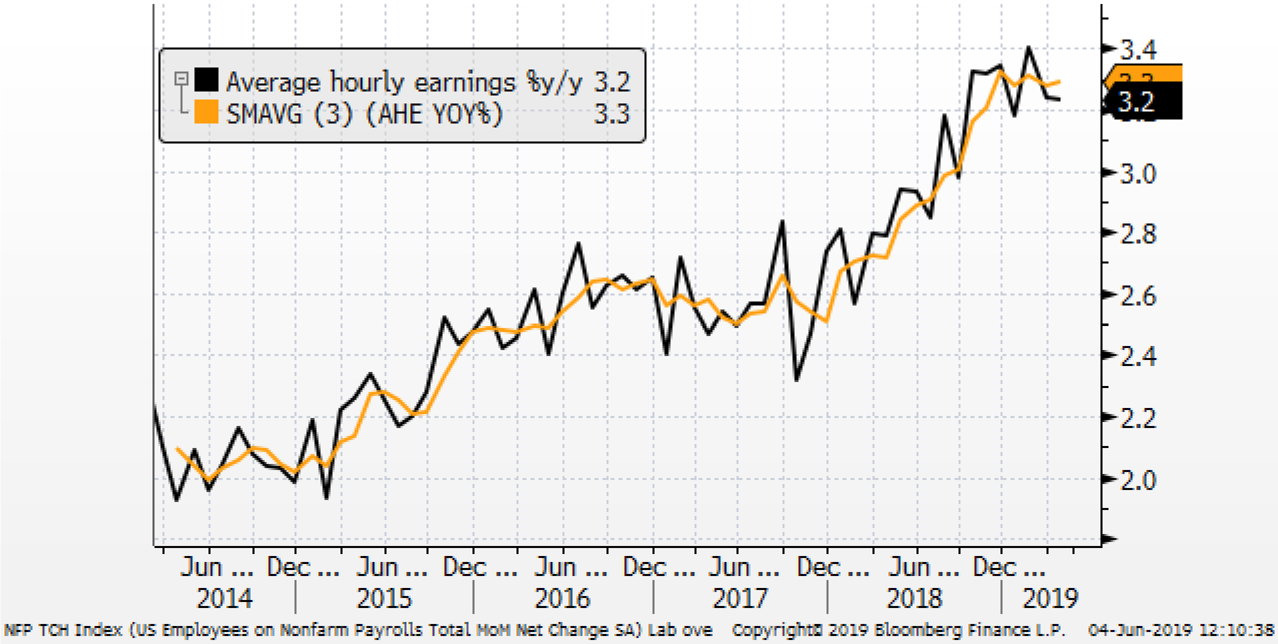


The PMI data suggest there is some risk of a weaker payrolls outcome. However, weekly unemployment claims remain solid, around their lowest level since the 1960s over the last year.

The market expectation is for the unemployment rate to be unchanged at 3.6%, a low since the 1960s



The tight labour market is generating higher wage growth. The market expects wage growth to be unchanged at 3.2%y/y in May



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