Eyes on the data

Despite policy paralysis economic data releases continue to paint an upbeat picture

News Analysis

by
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Implied expectations of future monetary tightening from the US Federal Reserve (Fed) continued to recede over the course of the past week, notwithstanding a number of relatively upbeat economic releases. Factory orders were strong and the March ISM report pointed to further gains in the manufacturing sector, whilst an optimistic read on the labour market was seen in the monthly ADP Employment release. It has been interesting to observe that strength in the small business sector seems to be lifting the US labour market following on from strong gains in small business confidence and acceleration in the rate of small business formation since the start of the quarter. This could bode well for the payrolls report due later today, allowing for expectations that there may need to be some payback after last months' strong release.

Notwithstanding this, markets appear to have more of a mind to look for bad news rather than good news in the past week, amidst growing disenchantment surrounding the Trump Administration. Policy paralysis has led to calls that data releases are set to disappoint in Q2 after a robust start to the year – yet in our eyes, the US economy currently retains substantial momentum and a June rate hike looks likely, even absent any policy delivery from Capitol Hill. In this context, the Fed Minutes this week stand as a reminder of the Committee's expected path to policy normalisation. Although the notion that the FOMC plans to taper or cease the re-investment of maturing bonds on the Fed balance sheet as we move into 2018 generated plenty of headlines, we would not view this as a surprise. Rather we feel that it is more important to remember that the Fed sees a gradual balance sheet reduction proceeding hand in hand with rate rises in the year ahead, with the median dot plot inferring two more hikes in 2017 and a further three moves in 2018.

We have believed for some time that Janet Yellen will want to leave office early next year having seen the labour market reach full employment, inflation reach its target and for interest rates and the balance sheet to be set on a course towards normalisation. Although an end to re-investment means more net Treasury supply and should infer higher longer dated yields, we would not overplay the significance of this step in economic terms. By contrast, were we to see John Taylor installed as the next Fed Chair, then there could be a move to actually sell down the Fed balance sheet more assertively and this could be much more disruptive; yet this would also need to be understood based on his stated desire to see both a much small Fed balance sheet and higher interest rates at the same time, meaning that were he appointed to office, we think this could lead to a material bear steepening of the yield curve.

In the eurozone, Mario Draghi and colleagues have continued to push back on the notion that the European central bank (ECB) is close to withdrawing monetary accommodation in the eurozone. Following a soft core CPI print last week, the ECB seemingly wants to correct market speculation that rates could rise later this year and this has helped to push Bund yields somewhat lower. Elsewhere, all eyes were on the marathon four hour TV debate between the 11 French Presidential candidates (actually running a marathon would probably have been much more enjoyable and rewarding than sitting through this!). Little new information could be gleaned and as we head towards the first round of voting later this month, market probabilities have remained largely unchanged. Meanwhile, in the UK, Brexit negotiations commenced with a childish spat over the sovereignty of Gibraltar – reminding us all that talks are likely to be acrimonious and the atmosphere distinctly childish in tone.

Credit markets were relatively quiet in the past week, though spreads were pushed somewhat wider as equity markets retraced lower. In emerging markets, South Africa made most of the headlines with President Zuma dismissing Pravin Gordhan, the highly regarded finance minister, in a move which triggered a cut to junk credit status by S&P. We maintain no exposure to South Africa in the strategy and whilst this is undoubtedly bad news for the country in question, we see relatively few implications for the broader asset class. Of more significance, oil prices managed to consolidate above $50/barrel during the past week and although we see the upside in crude as capped by expanding shale output, we believe that robust global demand should help avert a slide much lower in prices in the near term.

Looking forward, near term thoughts will be dominated by the US labour market report later today. We are struck by the sense that many fixed income investors have formed a downbeat view on the US economy coming into Q2. We feel this is wrong and any hype about a slowing in activity is nothing more than fake news in our opinion. Recent price action has been testing for our positioning, but this leaves the forward looking prospective return profile in assets like Eurodollar contracts looking even more asymmetric in our view. Mind you, if US markets look like they are detached from reality, the less said about the situation facing the UK following Article 50 the better…