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Global Macro 360

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Weekly Note: Investing in a more volatile world

23-February-2018

After one of the biggest bust-ups between Bonds and Equities in two decades, markets are normalizing at a pace that may make recent events look like just an intra-month stumble. Equity volatility has retraced two-thirds of its early-February spike; stocks have retaken half their 10% peak-to-trough decline; oil has recovered one-third of its losses; and the trade-weighted dollar is within a whisker of new three-year lows. Still, volatility across rates, currencies, and equities remains above levels witnessed in the second half of 2017, highlighting that 2018 deserves to be less orderly than late 2017 even if the first half of the year shouldn't be as harrowing as early February.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	0.99%	-4.53%	1.48%
S&P 500	1.60%	-3.81%	2.27%
RUSSELL 2000	-0.36%	-2.86%	2.62%
NASDAQ COMPOSITE	4.79%	-2.39%	3.61%
Euro Stoxx 50	-2.53%	-5.37%	1.35%
FTSE 100	-5.81%	-3.89%	0.37%
DAX 30	-3.99%	-5.97%	0.51%
NIKKEI 225	-3.49%	-6.21%	3.86%
HANG SENG	5.06%	-4.16%	6.69%
S&P/ASX 200	-2.00%	-0.54%	1.75%
EUR-USD X-RATE	2.63%	-4.88%	-1.04%
EUR-GBP X-RATE	0.47%	-4.43%	0.62%
Gold Spot $/Oz	2.04%	-1.56%	-1.58%
Crude Oil	1.57%	-6.45%	3.68%

The reason is US inflation which has printed stronger than expected on almost every measure over the past month (average earnings, CPI and PPI, but not the ECI and PCE). Even though we have been expecting labour costs and broader price gauges to firm this year as slack diminished further and transitory factors faded, we did not expect so many beats so soon. Neither did the market, which is why the ongoing bond bear market is delivering more volatility across rates, equities, and currencies than is typical for a rising rate environment, and consequently why stocks are rising and credit spreads tightening less than they typically do when Treasuries sell off.

On average over the past two decades, major UST sell-offs (those of +50bp) have been associated with about 5% gains on stocks and at least 20bp of spread tightening on US HG and HY. Since mid-December when 10Y rates began climbing, Equities are flat and spreads only 5bp to 10bp tighter (HG and HY, respectively).

We however remain optimistic that asset price returns for 2018 will be positive.

Confidence in this view is reasonably high, now that Congress has eased fiscal policy twice in two months. We continue to think the Fed will hike four times each in 2018 and 2019, and that it will upgrade its rate guidance at Powell's first FOMC press conference as Chair on March 21st, given inflation's recent momentum. Note that this Fed view isn't based on an aggressive inflation forecast. The view simply recognizes the Fed's reaction function because it is serious about preventing a material overshoot of its target.

To us, the disruptive inflation proves for markets always depended on the asset class and the horizon, with Bonds and some Commodities reacting first, Credit second and Equities plus EM a distant third. Inflation surprises would drive volatility. This sequence would roughly match the shift in relative performance across asset class as the economy transitions from mid to late cycle, since rising core inflation during this period has always triggered a Fed progression from loose to neutral to restrictive. While the party is not over yet, we may be entering the final act.

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