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Weekly Note: The Return of Volatility

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While it is tempting to jump straight into this week's market volatility – let's take a step back to the end of last week.

Friday's United States jobs report showed yet more strength. Non-farm payrolls rose 200k in January, and back data were revised up. At this point, trend payroll growth looks to be almost twice our roughly 100k estimate of the "breakeven pace". By contrast, the household survey was a bit light, with the fourth 4.1% reading for the unemployment rate in a row. The reason for the recent stagnation is that job growth in the household survey has been far below the establishment survey since mid-2017.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	-1.66%	-7.04%	-6.78%
S&P 500	-0.21%	-6.47%	-6.43%
RUSSELL 2000	-3.10%	-5.53%	-5.99%
NASDAQ COMPOSITE	0.70%	-6.20%	-6.09%
Euro Stoxx 50	-2.09%	-5.42%	-5.36%
FTSE 100	-6.24%	-4.32%	-5.00%
DAX 30	-3.65%	-5.64%	-5.70%
NIKKEI 225	-5.07%	-5.43%	-7.22%
HANG SENG	2.26%	-4.36%	-6.17%
S&P/ASX 200	-3.82%	-3.87%	-3.15%
EUR-USD X-RATE	2.83%	-6.44%	-0.46%
EUR-GBP X-RATE	-0.08%	-6.97%	-1.36%
Gold Spot $/Oz	1.94%	-3.38%	-0.79%
Crude Oil	5.73%	-6.45%	-0.96%

The biggest market mover in Friday's report was the rise in average hourly earnings growth from 2.5% year-on-year in the December report to 2.9% in January. While AHE is a noisy series, there are no obvious distortions that could explain the upside surprise; calendar effects should have been negative and the widely publicized once-off tax reform bonuses are outside the scope of AHE. Although minimum wage hikes may have boosted the month-to-month change in January, the surprise was concentrated among higher-paid supervisory and non-production workers and was mostly due to upward revisions to prior months where minimum wages shouldn't have been a factor.

With price inflation also recovering - the 3-month core PCE rate is back up to 1.9% (annualized) - investors have reassessed the Fed policy outlook significantly. The Fed funds futures strip now discounts roughly 100bp of tightening in 2018-2019, up from just 25bp as of last September. Fundamentally, we think there is still a lot more to come; our base case is that over the next two years, the Powell Fed will stay on the once-per-quarter tightening trajectory that the Yellen Fed put in place in late 2016. This would imply a total of 200bp of hikes in 2018-2019.

But following the big recent market moves, the repricing might slow for a while. This week's equity market correction shows that the expectation of tighter policy is now, at last, starting to weigh on broader financial conditions. We are not particularly concerned about the move so far; after all, FCI is still easier than a month ago. Nevertheless, it might indicate that the equity and credit markets will need some time to digest the recent repricing before taking the next step. This would be consistent with the experience from the "measured pace" tightening cycle of 2004-2006, when rates ended up rising much further than originally expected but the moves were incorporated only gradually into market pricing and thereby did not prove too damaging to financial conditions.