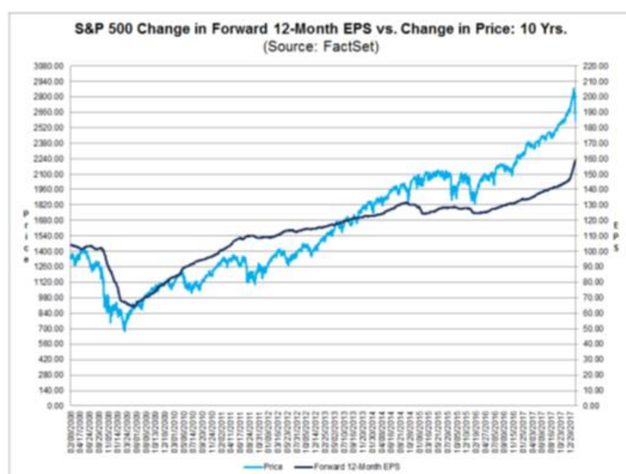
Small potatoes

The Week Ending Friday February 9th 2018

Wild, but not so wild. The 5% sell off in equities over the week added to the 3% fall the week before has certainly blown the froth off the stock market. Much better than expected sales and earnings figures had led to an excessively positive reaction in stocks (firstchart) – that has now been partly reversed. The long term forward Price/Earnings ratio (second chart) now looks more normal.



And perhaps that is all there is. The news about the spending deal, about wage growth, about rates is all just noise. Stocks had gotten over-exuberant and needed correcting.

The Fed remains in charge

The positive trends in growth seen in RGDP and NGDP data are still intact, just not that exciting. As Bill Dudley said, the stock market correction is just "small potatoes". Of course, as monetary policy advisers we (and the markets) do care a lot about what Jerome Powell may really be like, and we do care a lot about who Bill Dudley's successor will be, but things aren't that bad yet.

Sure, the markets and we would love to know what Powell is currently thinking but we will all have to wait until his next scheduled remarks in the annual Fed chair's testimony to Congress on 28th February. If things stay volatile, ie downwards, then it will be Dudley's job to calm markets via the usual ad hoc interview. Despite what some commentators think, the Fed put remains very much in place.

Bonds moved little over the week

We maintain that a flatter yield curve is a good thing if it occurs at a higher level of yields. A flatter, but much lower curve is a bad sign for future growth. The rising yield curve since the start of 2018 has been a good thing. Last week it was halted and even been partially reversed at the short end. This helpful self-correcting mechanism is a good sign that markets have confidence that the Fed would slowly ease monetary policy (indicated by slowing the projected rate increases) if the volatility worsens – exactly as Dudley said in his interview on Thursday – even if the market only heard him say "small potatoes" in the first instance.

The 5 and 10 year yields have stayed put at their highs. The news about the extra fiscal spending has made a lot of headlines, and we think it could be positive, but the projected 5% deficit (as a % of GDP) means the debt/NGDP ratio won't move a lot as the US achieves 5% NGDP growth – remember debt itself is thankfully nominal not real. We are forecasting just over 4% NGDP growth at the moment, admittedly down from the near 4.5% highs of a few weeks ago. Could be worse.

The USD stopped falling and recovered some modest ground. What growth the US is seeing seems more real than nominal and thus should not lead to a falling USD.

Data

It was a very quiet week for data even if markets were very noisy. The weekly jobless figure hit a low but shouldn't be big news. The wrongly-interpreted wage data the previous week seems to have gradually been understood correctly. The Markit PMI surveys of US manufacturing and services show an economy doing OK but not great. The global growth figures remain good as evidenced by the relative strength of US companies with more than 50% of sales and earnings outside the US.

Next week we see the already bullish NFIB Small Business Optimism Index. This should be interesting now that the tax cuts have been formalised. Market hawks hope that January CPI will show a take-off in nflation, as usual expecting some mythical Phillips Curve take-off inflation. We are more sanguine, as ever, and markets agree with us this time expecting a drop in core CPI.

The end of the week sees some early February Surveys from the University of Michigan and Philly Fed.