Weekly Market Flash

2017 Halftime Report

July 7th, 2017

Hard to believe it, folks, but Year 2017 has already passed its halfway point. While many are still getting the most out of a holiday-interrupted week, at the beach or in the mountains or anywhere that the Twitterverse cannot find them, we will take this opportunity to contemplate what was, what is, and what may lie ahead in global asset markets.

Sweet and Sour

Perhaps the definitive image of markets for the first six months of the year was a contrast in shapes: the flattening contours of the Treasury yield curve on the one hand, and the upward-sloping progression of the stock market on the other. For much of this time, equity and fixed income investors seemed to be singing off two different hymn sheets: giddy expectations on the one hand and a dour read of the macroeconomic landscape on the other.

Going by the hard data alone, the bond mavens would seem to have the better arguments on their side. Headline data over the first two quarters largely underwhelmed, most notably in the area of prices and wages. Inflation readings, including the Fed's favored personal consumption expenditure (PCE) gauge, have stayed south of the central bank's two percent target. The labor market continues to raise more questions than it answers, with the unemployment rate suggesting we are very close to full employment, but tepid wage growth indicating none of the usual pressure that hiring firms experience in a tight labor market. That dynamic was present in this morning's jobs report as well. Better than expected payroll gains brought the three month average up to 194,000 new jobs, but wage growth again came in below expectations.

Turning Point or Tantrum?

With that soft inflationary context in mind, we consider the recent gyrations in the bond market that has some observers predicting a sea change in yields in the months ahead. The fixed income kerfuffle was ignited by remarks by ECB Chair Mario Draghi last week, suggesting that Europe's better than expected recovery may warrant moves to start winding down monetary stimulus. Whiffs of increased hawkish sentiment can be detected elsewhere in the central bank world, including the UK and Canada.

With inflation showing no signs of overheating, the Fed will not have a gun to its head to raise rates, nor will the ECB be forced to risk market volatility by accelerating any form of a taper in their bond buying program. But that very volatility is an issue on the table for the monetary mandarins. This week's release of the June Fed minutes suggests that central bankers are at least somewhat nervous about yet another characteristic of 1H 2017 asset markets: the coexistence of elevated prices with almost no volatility. The Fed's rate hike in June -- and a possible follow-on increase in September -- reflect at least in part an attempt to wrest control back from complacent markets. That complacency is well-founded; central banks have in recent years gone to great lengths to prop up asset prices. If investors sense an end to the Greenspan-Bernanke-Yellen put, we could expect volatility to return with a vengeance.

Brent Gold, Texas Tea

Another addition to the #thingswelearned category in the first half of 2017 is that OPEC is largely a spent force in exerting influence on oil prices. The cartel's much-touted meeting last fall that produced a tangible production cut policy initially sparked a recovery in crude prices, but the recovery fizzled away as it became ever clearer that US non-conventional drillers, not OPEC, represent the marginal barrel of production. Supply dynamics suggest a secular trend for the range-based price movements of recent months, with the only question being where the lower end of that range will settle. On the demand side, the continuing reality of below-trend global output signals that the commodity super-cycle of the previous decade is unlikely to return any time soon. Resource companies may be in for an extended winter of discontent.

Much More in Store

These topics are just the tip of the iceberg: we have said nothing here about emerging markets, or risk spreads in investment grade & high yield bond markets, or the strangely underperforming dollar, or sector and geographic rotation among equity asset classes as another season of earnings gets under way. These are all issues of clear and present importance, and rest assured we will be covering them in the weeks ahead.

Meanwhile, enjoy what remains of the holiday week and be ready for interesting times ahead as summer eventually brings us to those tricky fall months that lie in wait.

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