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MV Capital Management Weekly Market Flash

Yellen's Dilemma

August 1, 2014

Major U.S. equities indexes gave up all their July gains and more on Thursday, the final trading day of the month. The Dow Jones Industrial Average, which has lagged the S&P 500 and the Nasdaq Composite for many months, finished the day in negative territory for the year to date. Tellingly the pullback was sandwiched in between two events: the Fed Open Market Committee deliberations which ended Wednesday, and the July jobs numbers, released earlier this morning. Was this 2% reversal a brief event, a virtual particle popping into and out of existence within the blink of an eye? Or does it portend a double portion of toil and trouble in the weeks ahead?

Cruel Summer

One has to feel sympathy for Fed Chairwoman Janet Yellen as she and her Fed colleagues deal with a full complement of X-factors, good and bad, bubbling up in their policy cauldron. It is an unusually eventful summer. In addition to trying to sort out the U.S. macroeconomic picture and communicate clear forward guidance on interest rates to the market, there are the crises in Ukraine, Gaza and Iraq trading places as any given day's front page headline. Europe's economy is stuck in the doldrums and sits in the shadow of Russia, its principal energy supplier.

On the other hand, China seems to be back on track after concerns earlier this year about the sustainability of its growth trajectory in tandem with a major economic rebalancing. India's outlook appears somewhat more promising in the wake of May's elections bringing Narendra Modi and his business-oriented BJP to power. There are reasons for caution and reasons for optimism. That makes it difficult for the Fed to maintain tight consensus. We saw some cracks in the consensus with the holdout vote Wednesday of Philadelphia Fed president Charles Plosser. Tension over rate policy is likely to continue, and likely helped stoke the flames for Thursday's pullback.

Good News, Bad News

The economic data continue to accumulate more in the good news column. GDP grew at an annualized rate of 4% in the second quarter. Inflation is over the Fed's 2% threshold. But in the looking glass world of capital markets, good news for Main Street is often bad news for Wall Street. More jobs and higher wages mean tighter capacity, upward pressure on prices and, eventually, rate hikes. Breaking the six year zero-rate addiction will be hard.

Yellen caught a bit of a break with today's job numbers, though. Nonfarm monthly payrolls came in over 200,000 but below consensus expectations, and the unemployment rate ticked up slightly. In other words: good enough but not too good. Equity futures rallied on the jobs news, though they have pulled back into negative territory (as of this writing) as yesterday's selloff gets a second wind. It would certainly not be unheard of for a pullback of 5% or more to materialize. But at some point good news may just be good news, even on Wall Street. We'd be fine with a 10% correction if it were followed by a sustained, genuinely organic economic growth story.

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