Weekly Market Flash

Hot Jobs, Hot Bonds

October 5, 2023

Does anyone really know what is going on with the US economy? Anyone? Bueller? Recession chatter has been rising again in financial circles, as economists take note of tapped out savings and rising consumer debt levels. Then along comes the latest jobs report from the Bureau of Labor Statistics, showing that nonfarm payrolls rose by 336,000 in September, more than twice as many new jobs as those very same economists had predicted. That represents the largest monthly increase in payrolls since January. The unemployment rate is 3.8 percent, and while the third quarter GDP report is still three weeks away, the median estimate from Blue Chip Economic Indicators for Q3 real GDP growth is around three percent. The Atlanta Fed's GDPNow indicator predicts 4.9 percent growth. Make of it what you will, but those numbers are not exactly screaming recession.

Good News Is Bad News

Today's report was just one of three readings of the labor market that came out this week. A Tuesday report (also from the BLS) showed a much higher than expected number of job vacancies, followed on Wednesday by a survey from the ADP Research Institute suggesting that job creation was slowing down. As went the reports, so went the bond market. The yield on the 10-year Treasury note surged on Tuesday in response to the optimistic job vacancies report, then subsided on Wednesday with the cooler ADP survey. Yields are, predictably, soaring again today on the heels of those 336K payroll gains. The 10-year is now nearly on par with the 3-year and closing in on the 2-year, more than a year after the yield curve began its inversion in July last year.

What's good for the economy (more jobs) is treated as bad news by the market because it solidifies the view that interest rates are going to stay higher for longer. That is why we once again have the unusual positive correlation between stocks and bonds (remember that bond prices move in the opposite direction from bond yields, so this week's surge in yields has meant falling bond prices). The normal state of things is for investors to move into bonds when seeking safety amid uncertainty, and to toss off bonds in favor of stocks when animal spirits are feisty. A strong economy should be a catalyst for shifting the portfolio allocation weights towards more equities. But when the strong economy is seen as the rationale for a more sustained period of high interest rates, the math works out differently, as this week's parallel trend in bonds and stocks demonstrates.

Bond Vigilantes

Way back in the early 1980s an economist named Edward Yardeni coined the phrase "bond vigilantes" to describe how bond investors drive up interest rates when they have no confidence in the direction of US fiscal and monetary policy. Yardeni resurrected that phrase in a Financial Times article earlier this week, noting that a combination of lower tax revenues, higher Treasury outlays on debt servicing and increased government spending could lead to another spell of vigilante-ism in the bond market. That, in turn, could keep interest rates higher even after the Fed ends its monetary tightening, bringing about a genuine credit crunch. Eventually, under that scenario, a recession would likely be unavoidable.

Which brings us back to the question we posed at the opening of this article: does anybody actually know what's happening in the economy? The Fed sees a soft landing as increasingly likely, the bond vigilantes see things going off the rails, and all the while companies still seem to be throwing their doors wide open to bring in new hires. It's a confusing picture. There are plenty of things for the market to worry about, but there are also plenty of reasons for confidence, a strong labor market and continued GDP growth being among them. Our advice is to be prepared for surprises, but stay disciplined and avoid decisions based on emotional reactions to short-term developments. This, too, will pass.

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