Weekly Market Summary

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June Non-Farm Payroll, Market Complacency and the Bond Tapering Debate

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A month back, we suggested that June 4th would be a big day on Wall Street. Market focus at that time was on the crucial May employment release, seen as possibly one of the most - if not the most - important piece of economic data prior to the Fed's June 16th FOMC meeting, with substantial implications for stocks and bonds. Bloomberg consensus was for May Non-Farm Payroll (NFP) to show a healthy monthly increase of 675,000 new jobs, powered by growing demand for discretionary services and a boost in the goods sector, and for the unemployment rate to dip to 5.9% from 6.1% - a new pandemic-era low. The actual number came out close to expectations, with US employers boosting hiring by 559,000 whilst the unemployment rate fell more than expected to 5.8%. And yet, the slight shortfall in payroll growth - compared to economists' predictions - meant that the labour improvement was not strong enough to change the Federal Reserve's course on its easy-money policies (given that many Fed officials had repeated they would want to see a substantial improvement in the job market before adopting a clear timeline for tapering their large bond-buying programs). As a result, US stocks and bonds rose on the day, with the yield on the US 10-year US Treasury bond falling 7 bps (from 1.63% to 1.56%).

Since then, markets have witnessed further solid growth / inflation data as well as a more hawkish Fed tilt (even as Fed Chair Jerome Powell reassures investors that the bond tapering announcement will only come later this year and that the lift-off in benchmark US interest rates us well into the future). Yet, bond and equity prices continue sustaining a relentless rally, with the S&P 500 index closing at record highs yesterday (4,320) and the 10-year UST yield close to a 4-month low (last at 1.45%). The current depressed level of interest rates simply endorses the view of Fed officials that hotter consumer price pressure will prove transitory as well as market worries about a delayed pick-up in job growth. Irrespective of the near-term outcome, there is a sense that something doesn't seem right within markets and it is perhaps best explained by how all asset classes are rallying in tandem as a result of substantial and persistent support from central banks (in turn distorting market volatility and asset classes' historical correlations!)

Are Markets Totally Ignoring Increased Signs of Central Bankers' Nervousness and Divergence?

Since March 2020, and throughout the pandemic downturn, US Federal Reserve officials have spoken with one voice - promising that monetary policy would be set to full-stimulus mode until the crisis was well and truly behind Americans. Suddenly, they are less in sync. Central bankers are currently increasingly divided over how to think about and respond to emerging risks after months of rising asset values and faster-than-expected price increases. Whilst the Biden Administration and White House officials stay unified in maintaining that the recent jump in price gains will fade as the economy gets past a reopening burst, the Fed's top officials - including Chair Jerome H. Powell – have started acknowledging that a lasting period of uncomfortably high inflation is a possibility (with fewer voices still insisting that recent price increases will fade going into next year).

What seemed like a marginal possibility earlier this year (unwanted and persistent inflation that is) is now becoming a central feature of economic policy debates as prices rise for various items like used cars, airline tickets and restaurant meals. James Bullard is firmly in the hawk camp. The president of the Federal Reserve Bank of St. Louis has voiced more pointed concern in past two weeks that the pickup in prices might persist and suggested that the Fed may need to slow its support for the economy more quickly as a result. He is joined by Robert S. Kaplan, president of the Federal Reserve

Bank of Dallas and one of the early proponents for an end to the Fed's QE support. *"I see the debate and disagreement as the Fed at its best …In a situation this complex and this dynamic, if I weren't seeing debate and disagreement, and there were unanimity, it would make me nervous*."

The bubbling debate reinforces views that the central bank's easy money policies won't last forever, and sends a signal to markets that officials are closely tracking the latest pick-up in inflationary pressures. Officials are beginning to talk about when and how to slow down their $120 billion in monthly bond-buying (split between $80 billion in Treasury securities and $40 billion in government-backed mortgage debt) with clear hints that it might be wiser for the US central bank to slow its purchases of mortgage debt more rapidly than they slow bond-buying overall.

Fed policy debates have so far not have any material impact on financial assets (maybe because market players have stopped believing the Fed, thinking it's the "*Boy who Cried Wolf*" 😊), though they should soon start affecting markets. Bond-buying and low rates tend to pump up prices on houses, stocks and other assets, so the Fed's pullback could cause them to cool-off. And they matter for the economy: If the Fed removes support too late and inflation gets out of control, it could take a recession to rein it in again. If it removes its help prematurely, the slowdown in demand could leave output and the labour market weak. According to the International Monetary Fund (IMF), the Federal Reserve will possibly need to begin raising interest rates in late 2022 or early 2023 as increased government spending keeps inflation above its long-run average target. The U.S. central bank will likely begin to scale back asset purchases in the first half of 2022, staff from the Washington- based fund noted in a statement Thursday following the conclusion of so-called article IV consultations - the IMF's assessment of countries' economic and financial developments following meetings with lawmakers and public officials. "*Managing this transition - from providing reassurance that monetary policy will continue to deliver powerful support to the economy to preparing for an eventual scaling back of asset purchases and a withdrawal of monetary accommodation - will require deft communications under a potentially tight timeline*," IMF staff said in the concluding statement (and to think that there were good and rational times in the mid- to late-twentieth century when the Federal Reserve would remove the punch bowl – i.e. tighten monetary policy – without prior notice!)

The *June employment report** is slated for release over the coming hour (3:30 pm Bahrain time). All eyes will be on the monthly job increases as well as movements in the unemployment rate as investors and policy makers alike look for meaningful labour market improvement after the past two months of data came in lower than expected. Bloomberg consensus is for a 700,000 increase in NFP in June, the biggest increase since March. Whilst more US States did lift all remaining pandemic-related restrictions in June, many businesses have reported hiring challenges due to ongoing childcare responsibilities, enhanced federal unemployment benefits and lingering health concerns. Economists also expect the unemployment rate to dip to 5.6% from 5.8%, whilst average hourly earnings jump 0.3% month-on-month (3.6% year-on-year) following a solid 0.5% gain in May. Worth highlighting that US rates market will be more volatile than usual, as today's report is released in a shortened session before the July 4 long holiday weekend.

**The 850,000 jump in June Non-Farm Payrolls handily topped economists' forecasts, in contrast to misses on the downside in the two preceding months. As in April and May, the latest increase was powered by another big jump (343,000) in leisure and hospitality positions as the economy continued to reopen following pandemic-related restrictions. But the effects of Covid also have been playing havoc with the statistics. The separate household survey was mixed, with the headline jobless rate, or U3, rising by 0.1% to 5.9%, while the broader "underemployment" rate, or U6, fell by a sharp 0.4% to 9.8%. The competition for workers also pushed up wages: Average hourly earnings climbed 3.6% in the year through June and 0.3% over the month. Low-wage workers seem to be the biggest beneficiaries of the bump in pay.*

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