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Weekly Commentary

“Are you not entertained?”

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Key takeaways

- Volatility is up, bond markets are rallying, negative interest rates are prevailing in developed markets
- Labor market slack continues to subside and wage inflation pressures are building
- Market is pricing for a pause in the hiking cycle, Fed fund futures imply no additional rate hike in 2016

Full commentary

The first month and a week of 2016 has been a bloodbath with sharply wider spreads in fixed income risk assets and steep drops in equity markets. Through Friday, year-to-date excess returns are largely negative for US Investment Grade (IG) -2.63%, US High Yield (HY) -4.84%, and US Mortgage Backed Securities (MBS) -0.64%. Volatility is up, bond markets are rallying and negative interest rates are prevailing in developed markets. Investors are questioning the extent to which central bank policies can support financial asset prices. The strong correlation between oil prices and the prices of risk assets is unsettling. The carnage suggests that valuations are being driven by pressing liquidity needs and not by underlying asset fundamentals. But as we know, the market always has the last word on valuation and, for now, that means we set aside the fundamentals. We need to show some respect for the technical nature of the current trading environment.

The week’s economic data releases were mixed with a steady reading on ISM manufacturing at 48.2 and an ok reading on ISM Non-manufacturing at 53.2. We also received positive news on US auto sales but have also seen a recent rise in initial jobless claims up to 285,000 in the most recent week.

The non-farm payroll report on Friday was also mixed. The US economy added 151,000 jobs in January, which was a little weaker than consensus estimates. However, the unemployment rate fell to 4.9%, dropping below 5.0% for the first time since early 2008. And there was better news in the increase in average hourly earnings up 0.5% over December and up 2.5% year-on-year. There also was an increase in the work week to 34.6 hours. It would appear that labor market slack continues to subside and that wage inflation pressures are building.

Last week, the Bank of Japan surprised those who may have thought that the race to the bottom in the Developed Markets (DM) currency war would be an orderly one by moving to negative interest rates. This week’s comments from Federal Reserve (Fed) officials show that the US is not entirely ready to pass the baton over to others. Fed Vice Chairman Stanley Fischer, only a few weeks ago, was certain that there would be four rate hikes in 2016. In this week’s speech, he reiterated that monetary policy remains accommodative even after the December hike. Additionally, the federal funds rate is likely to remain low for some time and below levels expected to prevail over the long run.

Vice Chairman Dudley has recently highlighted how much tighter financial conditions are today than they were when the Fed voted to hike the funds rate in December. In their January statement, the Fed cited concerns about global economic and financial developments. Since that time, credit spreads have continued to move wider and equity markets have continued to move lower. The one respite is that the dollar has reversed its ascent against the euro and the yen.

It would seem that bond investors have less uncertainty about policy rates than the Fed. The market is pricing for a pause in the hiking cycle and, in fact, Fed fund futures imply no additional rate hike for 2016. Market pricing also suggests a much lower terminal value for the Fed funds rate. Bond markets are clearly assigning a greater probability to a recession in the next 12 months than is the Fed. Financial market volatility is likely with us for a while. And to answer Maximus’ question, the answer is “No. We are not entertained.”

This week’s market developments

Monday, February 1

- Markit UK Manufacturing PMI increased to 52.9 for January
- US Personal Income and Personal Spending growth decreased to 0.3% and 0.0% m.o.m. (s.a.), respectively, for December
- US Manufacturing ISM remained at 48.2 for January

Tuesday, February 2

- Eurozone Unemployment Rate decreased to 10.4% for December

Wednesday, February 3

- Eurozone Retail Sales growth increased to 0.3% m.o.m. (s.a.) for December
- US Non-Manufacturing ISM decreased to 53.5 for January

Thursday, February 4

- US Factory Orders growth decreased to -2.9% m.o.m. (s.a.) for December

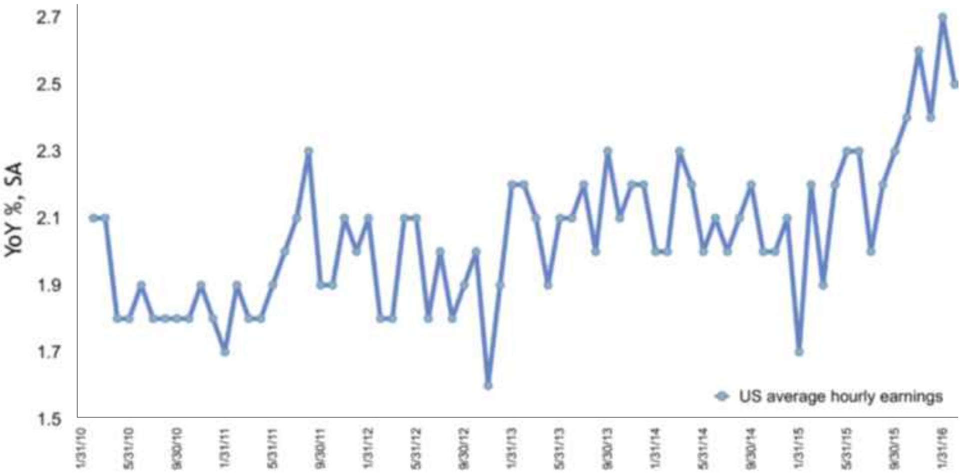
Friday, February 5

- Germany Factory Orders growth decreased to -0.7% m.o.m. (s.a.) for December
- US Change in Nonfarm Payrolls decreased to 151,000 (s.a.) for January
- US Unemployment Rate decreased to 4.9% for January

Source: Bloomberg, as of end February 05, 2016

Chart of the week

US average hourly earnings year-on-year % change



Source: Bloomberg

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.38 %	March 16, 2016
ECB	-25 basis points	September 4, 2014	0.05 %	-0.13 %	March 10, 2016
BoJ	-10 basis points	January 29, 2016	-0.10 %	0.11 %	March 15, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.60 %	March 17, 2016

Next week's market developments

Monday, February 8

- Japan Economy Watchers Survey for Economic Outlook is expected to increase to 48.4 for January

Tuesday, February 9

- Germany Industrial Production growth is expected to increase to 0.5% m.o.m. (s.a.) for December

Wednesday, February 10

- France Industrial Production growth is expected to increase to 0.2% m.o.m. (s.a.) for December
- France Manufacturing Production growth is expected to decrease to 0.3% m.o.m. (s.a.) for December
- UK Industrial Production growth is expected to improve to -0.1% m.o.m. (s.a.) for December
- UK Manufacturing Production growth is expected to increase to 0.1% m.o.m. (s.a.) for December

Thursday, February 11

- US Initial Jobless Claims are expected to decrease to 280,000 for the week

Friday, February 12

- Germany Fourth Quarter GDP Growth (preliminary estimate) is expected to decrease to 1.4% y.o.y.
- Eurozone Fourth Quarter GDP Growth (advance estimate) is expected to decrease to 1.5% y.o.y.
- Eurozone Industrial Production growth is expected to increase to 0.3% m.o.m. (s.a.) for December
- US Advance Retail Sales growth is expected to increase to 0.1% m.o.m. (s.a.) for January

Source: Bloomberg, as of end February 05, 2016