12TH MAY 2019

Global Strategy

INVESTMENT TEAM

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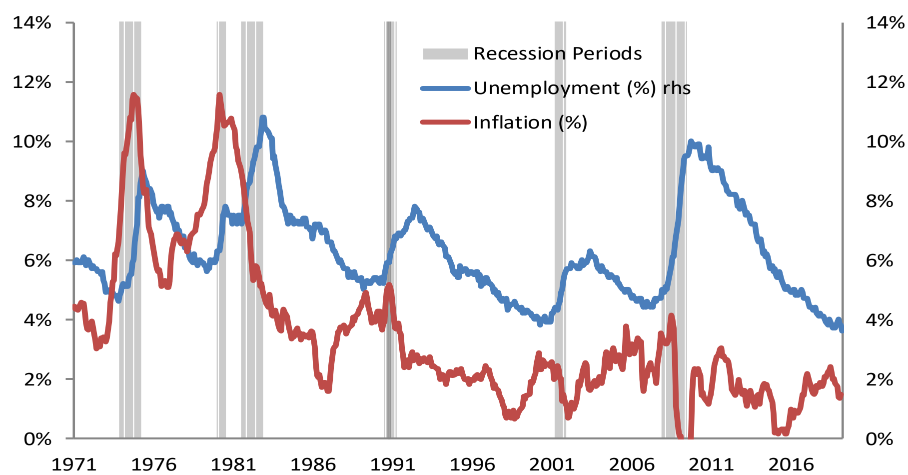
Sugar Sugar

When equity markets suffer a small set-back, it is often useful to take a step back and re-examine the fundaments. While growth is not as strong as it was, it remains relatively robust and the April Payrolls report surprise was testament to that, surprising to the upside on job creation and to the downside on wage growth. She is back, Goldilocks that is. As volatile as these numbers have been, and as close to the end of the cycle as we seem to be, it is difficult to see an imminent recession with the unemployment rate still falling and job creation so strong (not to forget the upward historical revisions to job creation). In previous cycles, recession has at least been contemporaneous with slowing job growth or a rising unemployment rate and neither seem imminent – the trends are still clearly growth positive. Strange then that the fixed income markets continue to price a rate hike by the end of the year. Life seems sweet for US jobseekers; hard to see why the bond market is so sour?

The Phillips Curve, which describes the theoretical inverse relationship between the unemployment rate and inflation, continues to be absent in the real data. This month's labour report showed weaker than expected wage growth at just 3.2% yoy which is also in line with the continuing softness in consumer price inflation. We chart the historic relationship between these two variables in Figure 1 and it is hard to pick out a correlation between the two. If there is any recurring relationship, it seems to be towards the end of the cycle, where the unemployment rate falls, and inflation rises. Inflation had been rising until the summer of last year, but it has been softening since.

Figure 1: US Unemployment rate versus inflation (yoy %)

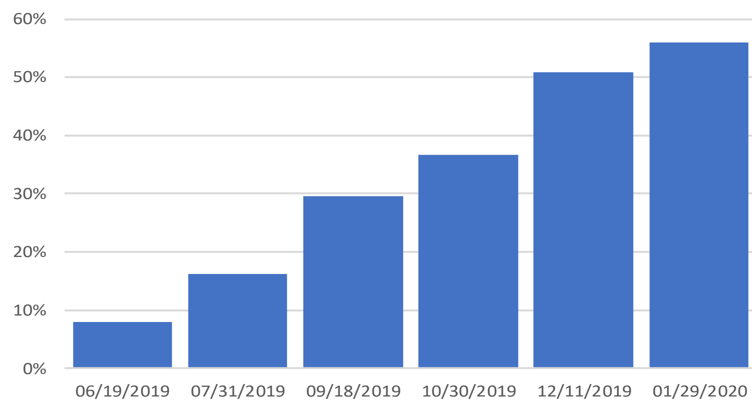


Source: DataStream, Canaccord Genuity Wealth Management

With the unemployment rate so low, it is hard to see why the labour market isn't generating more wage pressure and why the inflation rate is not higher than it is. Fixed income markets are pricing a rate cut before the end of the year (Figure 2) which is another way of highlighting the same dichotomy in the data. There is either a structural force keeping prices low, or demand is much weaker than the jobs growth would suggest. We expect higher wage growth to show through soon and for the bond market to capitulate. The recent equity weakness is likely to have temporarily bolstered the fixed income case for a rate cut. Equity markets did not recover into overbought territory, but that is almost always where they end up after a correction of the magnitude seen at the end of last year (Figure 3).

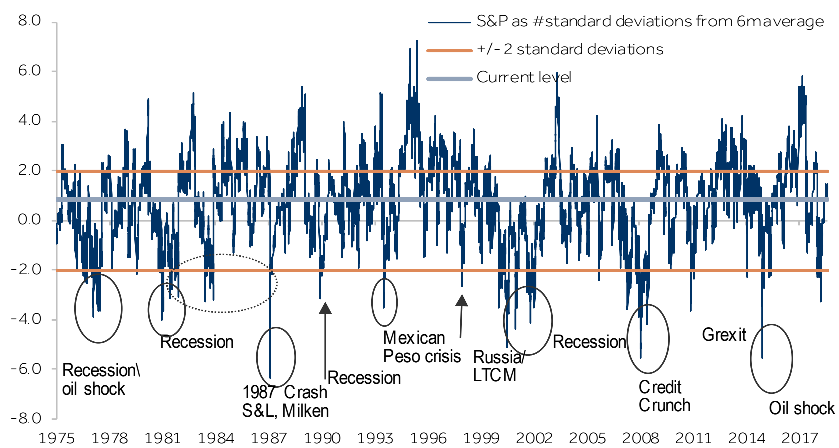
The last time the unemployment rate was this low, the Archies topped the Billboard charts with "Sugar Sugar". The song sold over 6 million copies and ranked as the top song of 1969 - the only time that a fictional band claimed that accolade. Wage and price growth are unsustainably soft against a historically low unemployment rate - you just couldn't make this up. Expect short end capitulation, a stronger dollar, and stronger equity markets.

Figure 2: Probability of a US rate cut (implied by US fixed income market)



Source: DataStream, Canaccord Genuity Wealth Management

Figure 3: US Equity Market Momentum (not meaningfully overbought)



Source: Bloomberg, Canaccord Genuity Wealth Management

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