Canaccord Genuity Wealth Management

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Global Strategy

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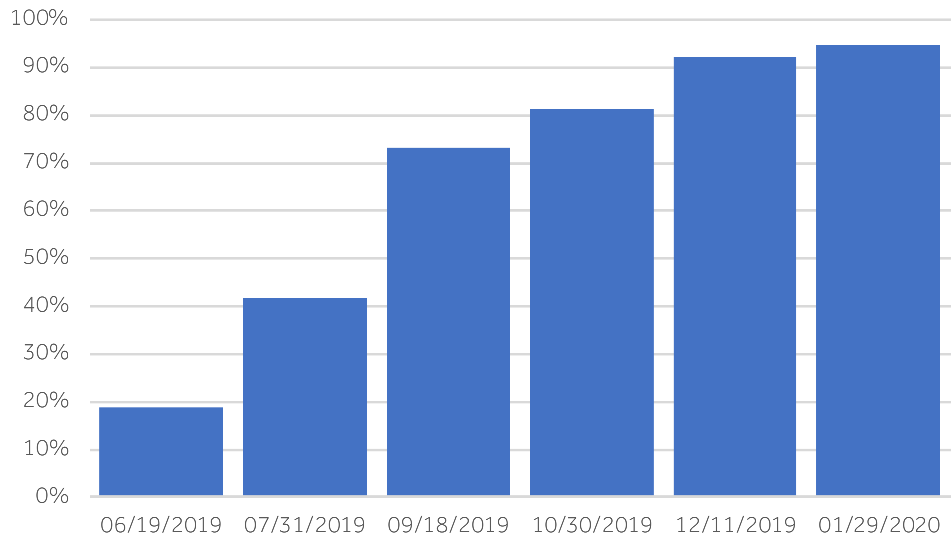
La Bamba

Last week fixed income markets moved to re-price the chance of a Fed rate cut this year, bringing forward that prospect to the September meeting. Also last week, Fed vice-chair Clarida obliquely mentioned that risks to the outlook might call for a rate cut. All this while Trump stepped up the trade war rhetoric again, this time with Mexico, and equity markets continued their move lower. We suspect that both short term rates and longer-term yields will go higher before the end of this cycle, and that wage growth will soon be seen as the canary in the inflation coalmine. If we are wrong, however, the first signs of doom will likely be seen in the employment numbers. It may be time to downplay trade war rhetoric and bond yields, and tune into signals from the labour market. We'll be watching the Friday release for good news this week.

May was a difficult month for equity markets, as they rolled back from their highs, with deflationary growth concerns once again rising to the fore. As soon as things seemed to be calming down, Trump last Thursday announced that goods coming from Mexico would be subject to a 5% levy from June 10th unless Mexico acted to avert the," migration crisis." He went on to announce that tariffs would continue to rise monthly to 25% in October unless steps were seen to be taken. Unsurprisingly, the US auto makers sold off on Friday, closely linked to Mexican imports, while fixed income markets continued to increase their probability assessment of a Fed rate cut, now seen as more than 70% likely at the September meeting (Figure 1). The prospect of higher import prices seems to be stoking deflationary fears. We think that is an overreaction.

Figure 1: Probability of a US rate cut (market implied)



Source: Bloomberg, Canaccord Genuity Wealth Management

The best guide to deflation prospects are likely to come from the labour market, but the relationship between unemployment and inflation is by no means perfect. To be sure, it is nothing like the stylised depictions in economic text books describing the Phillips Curve. In theory, inflation should rise towards the end of the economic cycle as the unemployment rate falls. A tighter jobs market is thought to increase wage pressures which in turn leads on to higher CPI inflation. That link is far from clear in fact (Figure 2). While the unemployment rate is at a 50-year low, headline inflation is not yet back to 2012 highs, let alone the last cycle. Wage growth is a better guide (Figure 3) and is at the highs for this cycle, and not too far off the highs of the last one.

So long as the economy continues to create jobs and drive down the unemployment rate, then wage pressures will continue to build. Forget the short-term drama of trade wars and calls for rate cuts, we suspect that the strength of the jobs market will soon mean higher bond yields and another rate rise. The equity bull market is not done yet - still time to dance the Bamba.

Figure 2: US unemployment rate versus CPI inflation

Source: DataStream, Canaccord Genuity Wealth Management

Figure 3: US unemployment rate versus wage growth

Source: DataStream, Canaccord Genuity Wealth Management

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