Economic & Market Snapshot

November 2018

In summary

Speculation about US monetary policy was the key factor driving markets in November. Comments from senior Fed officials led the markets to think the Fed is close to the end of its tightening cycle. This triggered a rally in bonds and equities, along with a lower US$. The resulting flattening of the US yield curve prompted speculation the US is heading for a recession in 2020. A sharp drop in the price of oil and signs of slowing outside the US reinforced the view that the Fed cannot afford to tighten much further. However, the markets appear to be getting ahead of themselves and have been very selective in how they have interpreted the latest news from the Fed and the economy. The odds are that the Fed has more work to do than the markets expect and that we will see more volatility and weakness in both bonds and equities as we move into 2019. Furthermore, the weakness in the oil price has more to do with supply factors than demand factors associated with slower economic growth.

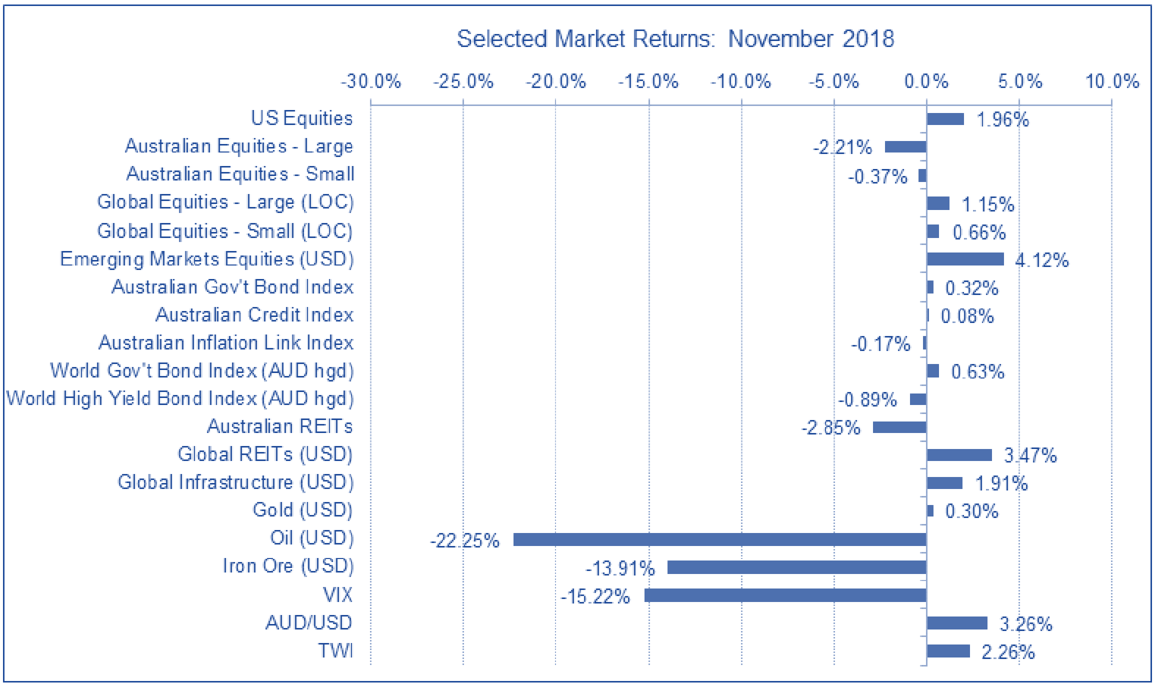
Meanwhile, conditions here in Australia show some slowing of economic activity, with weaker capital expenditure data, further falls in house prices and a weaker than expected GDP report for the September quarter. The labour market remains in reasonable shape, but wages growth is still muted. Under these circumstances, the Reserve Bank has kept the cash rate unchanged at 1.5%.

The trade dispute between the US and China waxed and waned through November, causing some volatility in equity markets. By early December, progress had been made on working towards a deal. The Chinese economy is starting to feel the impact of US trade policy, with signs that growth is slowing significantly. The authorities have started taking steps to offset this.

Theresa May managed to agree a Brexit plan with Europe, but now needs to get it through the UK Parliament. It looks like this will be unsuccessful and may even trigger a General Election.

The US mid-term elections proved to be a bit of a non-event and had little impact on markets.

Figure 1: The oil price collapsed in November as the market coped with excess supply



Source: Thomson Reuters

Key developments in November

November was another challenging month for global financial markets, though not as bad as October. The key theme for markets in November was a growing obsession with the notion that the Federal Reserve is running the risk of causing a recession in the US and will have to stop lifting interest rates. This sentiment was fuelled by some mixed messages from the Fed about how they see the stance of monetary policy.

The focus of central bank policy – in the US, Australia and many other countries - is where the cash rate sits relative to its "neutral" value, which is the cash rate consistent with the economy running at full capacity with stable inflation. Monetary policy is tight when the cash rate is above neutral and easy when it is below neutral. Unfortunately, the neutral cash rate is not directly observable – it is not set in the markets – but it can be inferred from economic models. The precise value of the neutral rate will depend on the assumptions used in the modelling. The members of the US FOMC, which sets interest rates, are asked to provide their estimates of the neutral rate. Currently, these estimates range from 2.5% to 3.5%, with the median sitting at 3%. The cash rate at the moment is 2.15%, so monetary policy is still on the easy side, even against a neutral rate of 2.5%.

Given that background, Fed Chair Powell threw the cat among the pigeons on 3 October when he said that monetary policy remains a long way from neutral. Markets immediately interpreted that to mean the Fed is going to lift the cash rate a lot more and equities sold off heavily.

In November, the Fed backtracked on this somewhat. First, Vice Chair Clarida said the cash rate is "by some estimates close to neutral" and that being at, not above, neutral would "make sense". He also noted signs of slowing in other economies around the world. The markets immediately took this to mean the Fed will not tighten much more and that to do so would be risky in a slowing world. A couple of weeks later Fed Chair Powell compounded this by saying the cash rate is "just below" the (2.5% - 3.5%) range of neutral. Markets thought this also meant the Fed was close to done with tightening.

The upshot of all this is that the markets rapidly downgraded their expectations for Fed tightening, causing bond yields and the US dollar to fall. Global equities and the A$/US$ also got a boost from this, but the local equity market lagged as resource stocks were hit by lower oil and iron ore prices. As US bond yields fell, so the yield curve (the spread between longer and shorter dated bonds) flattened, moving closer to zero. The markets took this as a validation of no more Fed tightening because flat to negative yield curves are seen as leading indicators of recession a year or so down the track. Markets are now talking about the US economy being in recession in 2020.

The dramatic fall in the oil price in October also contributed to this story. There is a popular belief that a falling oil price reflects slower demand driven by weaker economic growth. However, data provided by the New York Fed shows that supply factors drive the oil price much more than demand factors. At the moment, supply factors associated with the US embargo on Iran, as well as pressure on Saudi Arabia, have been driving the oil price down. The current OPEC meeting may lead to steps being taken to reverse this.

The markets also ignored a number of other statements from Fed officials warning that the path of interest rates will depend on the state of the economy and that it is too soon to sound the all-clear on further tightening. The markets did not want to hear this because it does not fit the popular narrative of the moment. This is characteristic behaviour of markets from time to time and can lead to reversals and volatility when the prevailing narrative fades. Our reading of the US economy says the markets are underestimating the Fed and that rates will go up more than expected, which will likely lead to more weakness in equities and the A$/US$.