SMBC Capital Markets, Inc.

fxPoetry

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Despite Admonitions

Now, what if the payroll report
Shows growth of the hundred K sort
While rate, unemployment
Removes the enjoyment
For bulls of the GDP sort?

Or what if the number is vast
Like double the current forecast
And joblessness stays
At three-six, sideways
Will equity bulls be aghast?

The problem the Fed Reserve board
Created is that they're ignored
Financial conditions
Despite admonitions
Keep falling while 'flation has soared

As markets are biding their time ahead of this morning's Nonfarm Payroll report, I thought it might make some sense to consider potential outcomes and their impacts on the market given one man's perception of the current reaction function. First, let's start with Bloomberg's listing of current expectations:

Event	Expectation	Last Month
Nonfarm Payrolls	250K	372K
Private Payrolls	230K	381K
Manufacturing Payrolls	20K	29K
Unemployment Rate	3.6%	3.6%
Average Hourly Earnings	0.3% (4.9% Y/Y)	0.3% (5.1% Y/Y)
Average Weekly Hours	34.5	34.5

Participation Rate	62.2%	62.2%

Let's start with a bit of recent history. The last time NFP was this low was the December 2020 print (Delta Wave) of -115K although In November 2021, the initial print of 647K was revised down massively to 249K. Otherwise, excepting the actual beginning of the pandemic in March and April of 2020, we need to go back to December 2019 to find a number like this. The point is, since the pandemic, there has been a steady, and large, recovery of job growth. Naturally, this has increased overall demand for both goods and services and is one of the reasons that inflation has been rising.

But with that in mind, let's play a little game and try to estimate how markets might respond to a few possible scenarios. On the weak side, what if we see NFP at 100K and the Unemployment Rate rises to 3.8% or 3.9%? Obviously, this would be seen as negative from the macroeconomic perspective and would support the view that the economy is already in a recession or likely heading there. So naturally, all that bad news would almost certainly result in a massive **rally** in both the stock and bond markets.

Huh? Here's the chain of thought: weak data leads to less inflationary pressures from weaker demand which will encourage the Fed to halt their rate hiking sooner and pivot more quickly to cutting rates to protect the economy since inflation will be falling. In other words, this will confirm the current market pricing where the Fed funds futures market is looking for the last rate hike in November and the first cut by June 2023. Meanwhile, the bond market, which is currently inverted by 36bps between the 2yr and 10yr, will likely invert further as medium-term inflation expectations decline and bond investors will pile in. At the same time, equity investors will look through the recession and see lower rates ahead which means that equity valuations should increase, and stocks should rise, especially the tech sector. In fact, financials are likely the biggest loser in this event. One last thing, the dollar should get smoked! This will be a signal to market participants that the top is in for the greenback and retracements to 1.10 in the euro, 120-125 in the yen and 1.30 in the pound will be on the cards (although not today).

On the flip side, what if the numbers work out with a 350K or 400K (or higher) print, with Unemployment remaining at 3.6% or even slipping a tick to 3.5%? Well, that unadulterated positive macroeconomic news is almost certain to result in a sharp **decline** in both equity and bond markets. Again, let's think through the ramifications.

Stronger economic data combined with the recent rebound in both stock and bond markets has resulted in looser financial conditions. It is this issue that will drive the Fed to an even more aggressive policy stance with estimates for a third consecutive 75 basis point rate hike in September likely to increase and the first discussions of a 100bps in the event that CPI next week prints with a 9 handle. This type of data will reinforce the Fed's view that the economy can withstand significantly higher interest rates and that until they act effectively to reduce demand, they will not be able to see "clear and convincing evidence" that inflation is heading back to their 2.0% target. And the dollar? This should prove quite beneficial for the buck, with a convincing break below parity against the euro and likely a push above 140 vs. the yen.

Admittedly, these are only two of a virtually infinite number of scenarios that may occur, but I believe they give a feel for the current good news is bad / bad news is good mindset in markets and why they exist.

One quick thing, financial conditions. What are they and why do they matter? There are several financial conditions indices around but a very common one is produced by Goldman Sachs. It is a weighted average of riskless interest rates (both 3-month and 10-year) as well as the dollar's exchange rate, equity valuations and credit spreads. Studies have shown that each of these has a relationship with GDP growth and this index was created to help track how current market conditions could impact growth going forward. As of yesterday, it sat at 99.18, down from its June peak of 99.70. For perspective, during the post covid monetary party, when stocks rallied every day and yields collapsed, it was at its all-time lows in the 97's. Looking back to the 1980's, when inflation was last at current levels, it never fell below 102. The long-term average of this indicator is 100.64, so we currently sit well below that level implying financial conditions remain loose. The Fed watches this closely and will want to continue to tighten these conditions in order to achieve their inflation targets. This means that both stock and bond prices will need to fall, credit spreads widen and the dollar will need to take another leg higher, or at least some combination of these things will need to occur before the Fed can relax.

With all eyes on the NFP, it should be no surprise that overnight activity was generally muted. Equities in Asia rallied but in Europe they are lower while US futures are virtually unchanged. Treasury yields are little changed and European sovereigns have seen the slightest of selloffs so yields there are a touch higher. Everyone has decided that oil is the worst lately, with a combination of ongoing releases by the Administration from the SPR helping to build inventories while all of the recession talk has traders believing demand will get destroyed. This is true in the energy sector broadly today, although nothing is collapsing, simply drifting lower. Gold has been a terrific performer for the past two weeks, rallying back 6.5% on what appears to be a combination of increased risk concerns as well as the growing belief that the Fed pivot is coming sooner rather than later.

And the dollar today is mostly stronger against its G10 counterparts, but only of the 0.25% variety, hardly anything to be concerned about while EMG currencies have seen a more mixed picture with some APAC currencies really performing well (THB +1.3%, KRW +0.9%, PHP +0.75%) with these currencies rallying on better tourist data in Thailand, better current account data in Korea and higher inflation data in the Philippines implying higher rates to come.

One other data point today is Consumer Credit (exp $27.0B) which remains extremely elevated, although well off the crazy numbers seen in March. It appears that people continue to borrow to pay for everyday expenses as wage growth continues to lag inflation, especially food and energy inflation.

There is only one Fed speaker, Richmond's Thomas Barkin at 8:00am this morning, ahead of the NFP release, but you can be sure that he will join the recent chorus to try to get the market to understand they really mean it this time when it comes to tightening policy.

At this point, all we can do is wait for the print. If pressed, my sense is we are going to see a weaker number, something like 100K-150K with all that entails for the market as per the above.

Good luck, good weekend and stay safe
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