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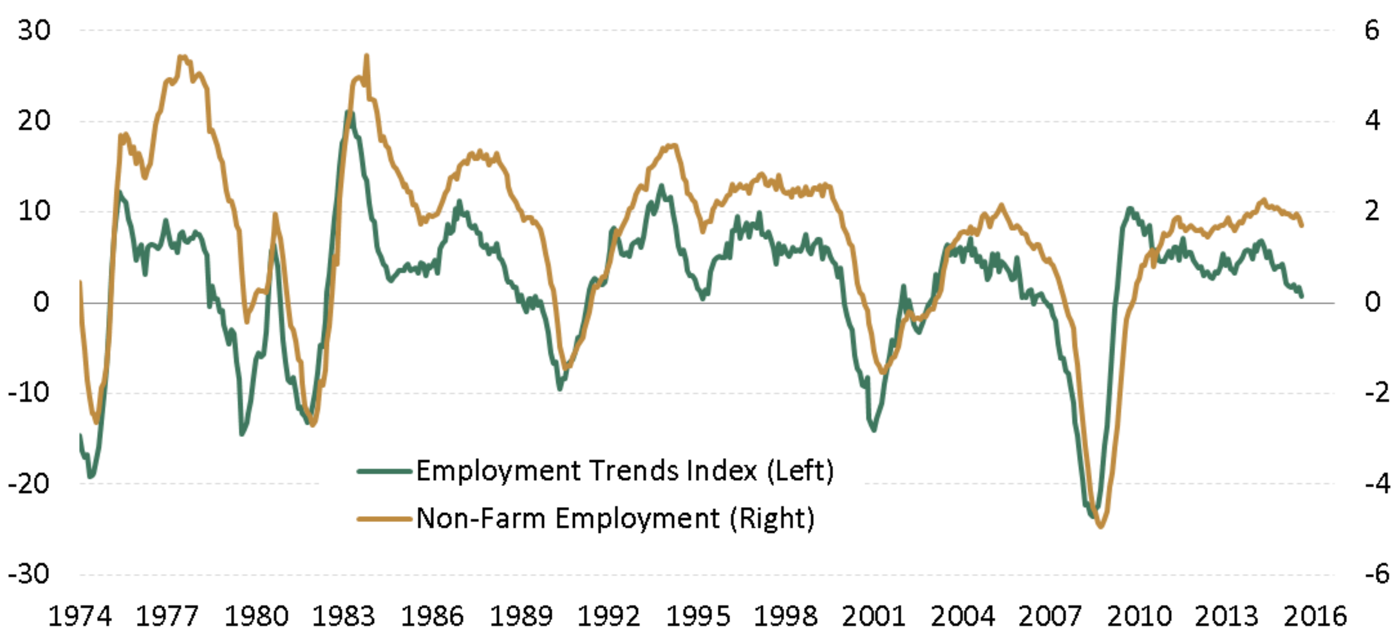
Is a Regime Shift at Work?

Does the recent disappointing U.S. payroll report mark the beginning of a broad-based downshift in the labor market, or is it simply a one-off blip? If it is the former, a regime change could be underway, one that will be characterized by a weaker U.S. dollar. If it is the latter, the dollar could regain strength, with the Federal Reserve (Fed) resuming monetary tightening sooner than later.
The investment forecast community is divided on the outlook for the job market, with some arguing that the bad jobs report is a statistical aberration. Others believe that the slowing trend in job growth might have been in the making for some time, and could be the start of an entrenched trend.

When using the Conference Board's employment trends index as a leading indicator, the weaker-than-expected June 3 jobs report looks more like the beginning of deterioration, which seems long overdue, rather than an aberration (see Chart 1).

Chart 1: Employment Showing Signs of Weakness *Annual % Change; As of 5/31/2016*



Source: Thomson Datastream

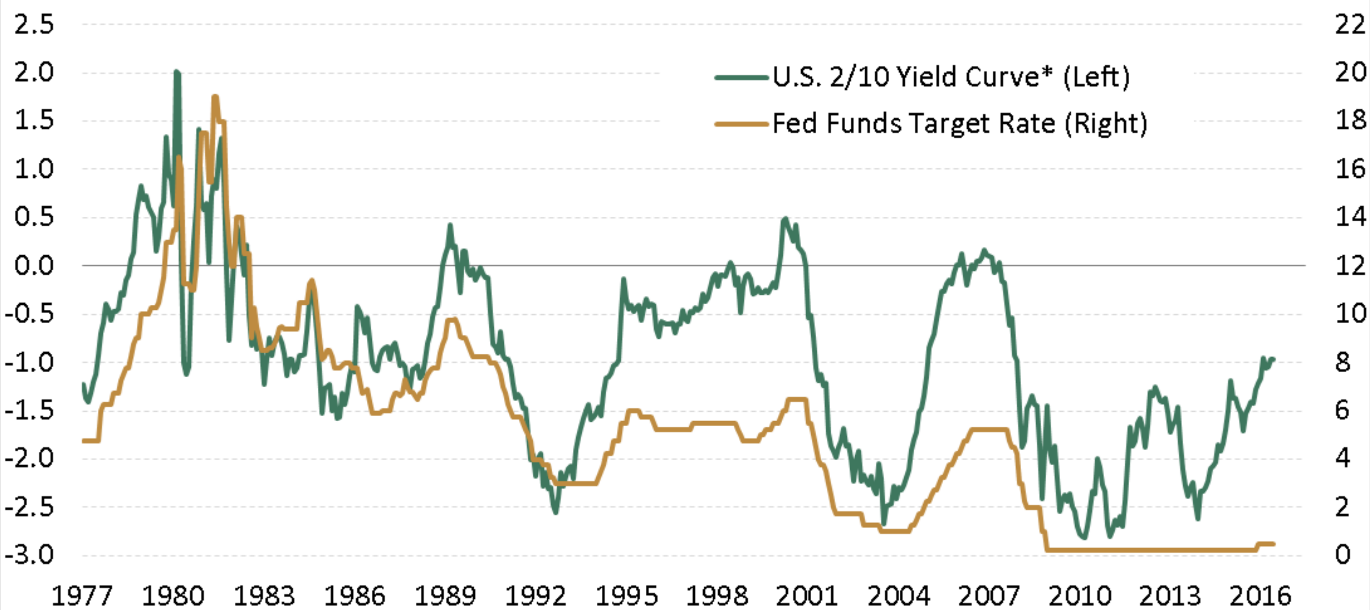
From an economic viewpoint, it makes logical sense to see some weakness in private payroll growth on the back of the U.S. corporate profit recession, subdued nominal gross domestic product (GDP) growth, and the strong dollar since 2015. Although much of the profit contraction is attributed to the energy and materials sector, overall nominal GDP growth has been anemic for some time. Against this background, it is actually surprising that job growth has held up so well until now.

Most Fed policymakers, including Chairperson Janet Yellen, believe that monetary policy is very accommodative. This perspective may well be an erroneous judgement. Most market-based indicators, such as the equity/bond ratio and yield curve, suggest that monetary conditions are not easy at all.

It is particularly worth noting that the Treasury yield curve is the most reliable indicator of underlying monetary conditions. A flattening curve is virtually always indicative of a monetary condition that has become progressively tight relative to the future outlook. By historical standards, the current yield curve is consistent with a position that is roughly two-thirds into a full monetary tightening cycle (see Chart 2).

In other words, a substantial amount of monetary tightening has already been delivered to the economy. A strong dollar, wider corporate spreads, the ongoing turmoil surrounding Brexit, and deteriorating profit margins have all served to tighten monetary conditions, substantially reducing the need for additional rate hikes by the Fed.

Chart 2: Current Treasury Yield Curve Indicates Tight Monetary Conditions %; As of 6/23/2016



*2-year less 10-year Treasury yield
Source: Thomson Datastream

If the U.S. labor market indeed enters a soft patch, it could prolong the "sweet spot" for risky assets. The dollar could either be stuck in a range or soften, and bond yields may not move up very much either. U.S. equities could shift higher due to easier liquidity and improving corporate profits on the back of a softer dollar. The euro and yen could stay firm as Brexit volatility begins to subside in the aftermath of the historic referendum, while growth in both Europe and Japan improves, albeit marginally.

As for emerging markets (EM), we believe that most Latam countries would welcome a weaker dollar as it would support commodity prices, improve their terms of trade, and undercut domestic inflation. All of these factors would allow EM central banks to ease and domestic interest rates to fall. However, Asian central banks will likely lean against their currency appreciation as they still face weak pricing power, overcapacity, lingering manufacturing recession, and trade price deflation.

It is worth emphasizing again that the current environment looks very similar to what we went through in the late 1990s when the Fed backed off from its rate hikes in the middle of the emerging market crisis. That action led to a lull in the dollar bull market, a corresponding rebound in commodities, and a sharp rally in EM assets.

The difference today is that the yield curve is much flatter, but stocks are significantly cheaper than in the 1990s when there was a mania in technology sector. Could this mean that the advance in risky assets would be much more muted when compared with the late 1990s, but last longer?

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