The global obsession with US data

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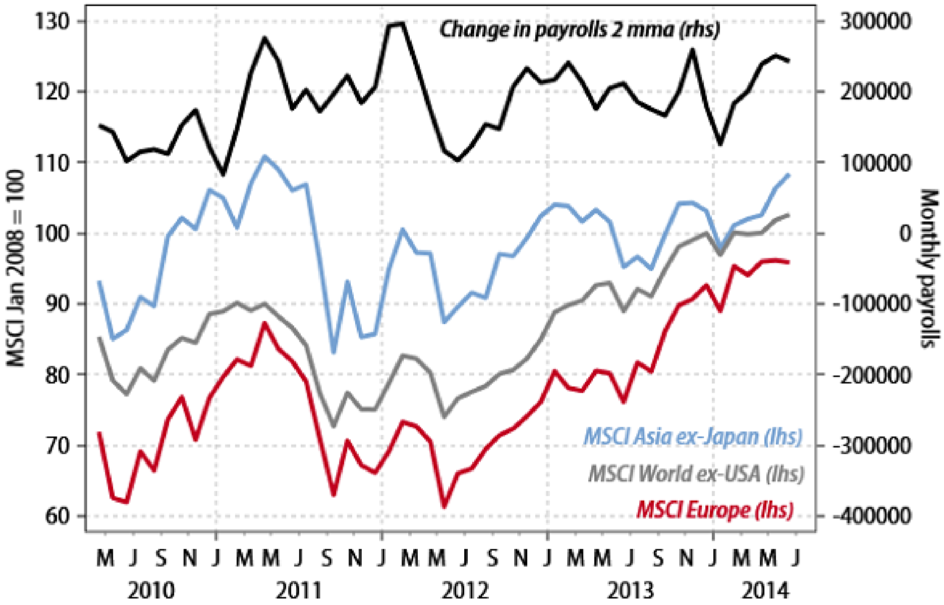
In the first article in this series, I argued that what is happening with the global economic cycle strongly influences investors' beliefs about structural phenomena such as productivity, demographics, capital allocation and debt dynamics (see The case for a structural bull market). And, while it will take many years to settle all the debates between bulls and bears about productivity or debt sustainability or zero interest rates, the cyclical outlook is now fairly clear, at least for US economic growth. Despite the first quarter's astonishingly weak gross domestic product figures, the US economy now seems to have reached 'escape velocity'. From this point, it can continue expanding and creating jobs, even in the face of exogenous shocks such as cold winter weather, geopolitical turmoil and the chaotic introduction of Obamacare. The situations in Europe and Japan are much less rosy, and the risk of an accident in China cannot quite be dismissed. But, above all, it is the sustainability of the US economic recovery that has been governing market performance around the world, as this article will explain.

As Figure 1 illustrates, since 2010, there has been an almost perfect correspondence between the peaks and troughs of two different series - the short-term cyclical strength of the US economy as measured by the two-month moving average of private payrolls (the black line) and the performance of stock markets outside the US. Even when Europe was in the throes of the 2010-12 euro crisis, the performance of European equities (the red line) was influenced more by US payrolls than by the European Central Bank or anything happening in Greece, Spain or Italy.

Figure 1: Global equities and US private payrolls



Sources: GaveKal Data/Macrobond

Of course, this could be a case of correlation without causation. However, there have been good reasons to link US cyclical performance with risk-on/risk-off sentiment around the world.

The US is not just the world's largest economy. it is also the country that led everyone else into the 2008 crisis and which ever since has been trying a series of unprecedented policy experiments in order to lead the world out again. After the US economic recovery began in late 2009, every run of disappointing jobs figures (the summer of 2010, 2011, and 2012 and then again last winter) has been viewed as a sign of US policy failure and a harbinger of a double-dip recession or secular stagnation, not just in the US but around the world. After all, if US$3trn of quantitative easing, five years of zero interest rates, and budget deficits equal to 10% of GDP were failing to pull the US out of recession, what hope could there be for other countries following similar policies more timidly?

On the other hand, whenever accelerated jobs growth signaled the end of a US soft patch, investors around the world concluded that US policies were working after all, albeit less quickly and strongly than their backers had predicted. And, if the US policy experiments were working, then Europe, Japan and other countries would surely follow, probably a year or two later.

A self defeating correlation

The result of this global obsession with short-term signals of US success or failure has been an extraordinary correlation of risk-on/risk-off cycles. But, if the argument is correct, it should soon become self-defeating. As evidence of a sustainable US recovery becomes established, the influence of US data on markets will diminish and the correlation shown in Figure 1 will break down. Internationally, individual markets will become more responsive to local domestic conditions instead of US figures - a pattern now visible in Europe and Japan. Within the US, short-term data fluctuations like the first quarter GDP figures will be dismissed as statistical noise.

Thus, as confidence in the US economic recovery increases, markets will become less macro-driven. What, then, will be the new driving force? Gavekal's framework has always been to analyse market prices as a function of three variables - economic activity, liquidity or monetary policy, and valuations. Since markets are moved mainly by what is least predictable, economic activity is becoming less important as a driver and attention is shifting to the other two.

In my next article, I will argue that monetary policy is now unusually predictable (whether we like it or not) since Janet Yellen, Mario Draghi and Haruhiko Kuroda are firmly in the saddle and bond-market vigilantes have become as scarce as unicorns. If I am right, valuations will emerge as the main driver of financial markets, with implications I will outline in the last of this four-part series.

Anatole Kaletsky is co-founder and GaveKal Research, GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.
