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Market Commentary

WEEKLY PERSPECTIVE ON CURRENT MARKET SENTIMENT

Root for Good, Not Great

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Last Week's S&P 500 Index:
+0.8%

Key takeaways

- *Stocks breathed a sigh of relief in the wake of the July jobs report, which showed fewer jobs were created than expected.*
- *The bigger positive was that the year-over-year change in average hourly earnings came in as expected.*

Last Friday's employment report, covering July, is a good example. The number of jobs created last month fell short of market expectations. In addition, the length of the average work week held steady versus June as did the very low labor participation rate. And perhaps most importantly, the year-over-year gain in average hourly earnings (2.7%) was perfectly in line with the consensus estimate. The stock market's reaction? A big sigh of relief as stocks finished the day and week with a nice gain.

I began by stating that last Friday's employment report is a good example. You might now be asking yourself, "The July employment report is a good example of exactly what?" It is a good example of the equity market reacting to economic news differently than many expected. Fewer jobs were created last month, but stocks rallied. This strategist would argue that right now economic news that is too good could be taken as a negative by investors. That may sound strange and nonsensical. After all, in this cycle, we are finally seeing economic growth at a consistently accelerated pace in the U.S. for the first time in this long expansion. How can that not be considered anything but a big positive for the stock market?

As do many things in the life of an investor and/or market prognosticator, it all comes down to what effect an accumulation of this better-than-expected (maybe even great) economic data might have on the Federal Reserve's (Fed) monetary policy decisions. These decisions, in the vast majority of occasions, decide whether a cycle lives or dies. Monetary policy that is too tight for a given level of growth discourages borrowing and spending and creates headwinds for a consumption-based economy like ours. Inflation usually starts to increase as the economy accelerates and input costs rise, the labor market tightens, and capacity utilization rates here and abroad work their way higher. One of the Fed's dual mandates is to strive for price stability. That is currently defined as a 2% year-over-year change in the "core" Personal Consumption Expenditures (PCE).

Now back to last week's report. For the last 12 months or more, the stock market has been laser-focused on wages. The market's belief, right or wrong, is that a surge in wage inflation will eventually lead to a meaningful rise in overall inflation. The Fed is known to watch wage inflation very closely. While many disagree about whether the relationship exists, one thing that often occurs later in a cycle that most analysts will agree on is that a jump in wage costs will cut into corporate profit margins. That's usually not good.

Right now, better-than-expected economic news might not be good for the stock market. Equity investors will likely interpret upside economic surprises as giving the Fed a green light to increase the pace and magnitude of rate hikes. So for now, especially in terms of labor data, root for good, not great.

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