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Marketnomics in action

In the last of a four-part series, a fictional case study tests the reader's understanding of economic influences on the market.

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Current situation: The U.S. GDP has been growing at an annualized real rate of 4.5% in the past 6 months. Last year, the GDP grew at a real rate of 5.0% and the year before that at a real rate of 4.8%. The output gap has been closing. Currently output is running at only about 2% below theoretical capacity levels. Purchasing managers indices have been reading well above 50 for the past 2 years. Inflation as measured by the CPI has been under control at an annual rate of 2.2%, core CPI is running at a rate of 1.5%. Producer prices as measured by the Producer Price Index have been rising at a rate of 5%, while core PPI has been running at 4.2%. Productivity levels have been increasing over the last 2 years but at a decreasing rate in the last 6 months. Employment growth has been strong, and the current unemployment rate is 3.2%. Hourly wages have been moving up slowly but steadily. The Fed has increased interest rates twice in the past 6 months, each time by 25 basis points. Statements from the Fed Chair make it clear that its fight against inflation is still on and that the environment exists for increased inflationary pressures. The next Fed meeting is in 3 weeks. At the last Fed meeting, interest rates were left unchanged but with a bias for tightening.

Economic Data To Be Released:
8:30 – Employment situation
9:00 – CPI
10:30 – Capacity Utilization

Markets are nervous going into the trading session because of the number of economic data releases coming out. In anticipation of the data releases, interest rates have been steadily moving higher in the past week, and markets have priced in a further 25-basis-point rate increase by the Fed at the next meeting and another 25 basis points at the meeting after that. These indications are reflected in the Fed Funds futures contracts. The yield curve has become very steeply sloped from 30 days out to 10 years as the market moves interest rates higher in anticipation of higher inflation and rate increases from the Fed.

8:30 AM
- Non-farm payrolls +180,000 vs. expectations of +130,000
- Previous month revised to +110,000 from + 90,000
- Unemployment rate 3.0% vs. expectations of 3.1%
- Previous month revised to 3.1% from 3.2%
- Average hour earnings + .3%

U.S. Treasury markets sell off dramatically. In the first minute after the announcement yields are up from 2 years to 10 years by 25 basis points across the board. Dow 30 futures drop by 100 points. NASDAQ futures drop by 30 points. A trader on the floor of the Chicago Board of Trade is on television telling the market that the Fed has missed the boat. Inflation is obviously rising faster than expected, and the Fed will now likely increase rates by 50 basis points at its next meeting.

Over the next 15 minutes, treasury and equity markets continue to sell off. Bond yields and T-Bill yields continue to rise. Equity futures continue to sell off. As the clock heads to 9:00 and the release of the CPI data, markets begin to settle, waiting for the next piece of news to indicate which way to move.

9:00 AM
• CPI + .3% in the month, 2.4% Year over Year; same as expected.
• Core CPI + .2% in the month, 1.7% Year over Year; same as expected.
• No revisions to previous month.

Perhaps inflation isn't as bad as first anticipated. Treasury markets rally and recover half of the early-morning losses within the next hour. Equity markets open down but not as much as predicted by the futures prices. After opening down and trading within about a 10-point range, stocks seem to find a point of stability waiting, along with the bond markets, for the next piece of information.

At 10:25 AM, rumours begin circulating through the market that the Fed is going to act before next Wednesday's meeting. Interest rate and equity markets rally on this "news" and recover more of the losses suffered earlier in the day.

10:30 AM
• Capacity Utilization 86% vs. expectations of 83%, up from 82% previous month.

Equity and bond markets sell off once again. Both markets begin to test the lows of the session to see where support is. After trading in a volatile range for the next hour, prices settle out near the day's lows. 10-year interest rates have risen by 35 basis points. Short-term interest rates have risen by 50 basis points. The Dow average is down 120 points and the NASDAQ, down 45 points. It appears that after the flurry in the early part of the day markets and traders are tired. The Fed made no moves at its usual time, which countered the rumours and helped the markets drift lower and settle out at the day's low levels.

What happened and why did it happen?

North American financial markets are terribly short-sighted. They move from hour to hour, day to day, quarter to quarter. As we discussed in the first article in this series (*Marketnomics 101: What do the numbers mean?,* Canadian Treasurer, February 2003)

there is little long-term focus or outlook. As a result, perhaps our markets are more efficient (a debatable point) but also more volatile.

Much of the market's movements are based on expectations. Hordes of analysts and economists expend astronomical amounts of resources in predicting what the economy is doing and what corporate activity and profits are doing, and this translates into market movements. While these people have quite sophisticated tools at their disposal, they are far from perfect. As a result, the set of expectations and predictions that are published at any given time are as likely to be wrong as right. Nevertheless, markets and market participants use this information as the basis for their trading decisions. When reality turns out to be different from what was expected, traders are positioned wrong and corrections need to be made. Few things strike fear into markets more than inflation. This stems in large part from previous periods of high inflation and low growth (stagflation) that the economy has endured in the past. No one wants to return to that environment. While central banks have been very effective in the last 10 to 15 years at wringing inflation out of the economy, there remains a fear that, if they don't remain vigilant or if there is a change in philosophy at the head of a central bank, damaging inflation could very easily return. The primary concern in the scenario above was inflation.

If employment is rising and unemployment falling, this means that there is a lower supply of available workers and wages will begin to be bid up as companies compete and increase demand for a given supply of a commodity. (Let's face it, while people may not like being regarded as a commodity, that's exactly what we are). As wages increase, prices begin to increase, first at the intermediate or producer level. Intermediate goods providers begin passing their increased prices on to their customers. This means that the next link in the chain has to deal with two increases: increased wages to its own workers and increased prices from its suppliers. As you go further along the chain, you can see how this effect could snowball. Ultimately all these price increases will be passed along to the consumer. The consumer, seeing his cost of living increase, goes back to his employer and bargains for yet higher wages. And the cycle begins again. This is known as the wage-price inflation spiral.

Are there mitigating factors that can prevent price increases from being passed along? Absolutely. One of the most influential factors is a productivity increase. With increased productivity, companies can produce more in the same amount of time or the same amount in less time or with fewer workers. As long as productivity increases at a faster pace than wage and other input prices, consumer inflation can remain subdued. These productivity increases mean that producers and suppliers can maintain or increase profitability even in the face of increased input prices. Productivity increases can result from improved processes or improved technology. Improvements in technology can mean increased investment in new plant and equipment. This further spurs economic activity in other sectors.

To the extent that companies borrow to finance this new technology, then increased demand is placed on the supply of funds. As long as liquidity remains and there is enough money to go around, interest rates will remain low. As increased borrowing levels begin

to put a strain on the available resources and investors have more investment options available to them, they will demand increased return, and borrowers will be prepared to bid up interest rates in an effort to attract funds. To a point. At some point, borrowers will begin to scale back borrowing and purchasing of new plant and equipment because interest rates are too high. If they can't pass these increased costs down the line, their profits will begin to erode. Along with the tools used by the central banks, this can act as a natural brake on economic growth.

How does all this affect your typical corporate treasurer? It means that s/he needs to have a good handle on the company's financial exposures, the business cycle in general and the specific business cycle of his or her company. It means that the treasurer needs to be forward-thinking and try to implement policies and strategies that will insulate the company as much as possible from economic swings. The treasurer needs to be able to take advantage of economic conditions by being able to float fixed-rate debt in periods of falling interest rates, fix floating-rate investments during the same period and vice versa. S/he needs to understand the interplay between interest rates, the economic cycle and the value of currencies so s/he can maximize return or minimize cost on foreign currency revenues or borrowings. The corporate treasurer has to take a longer-term view than the markets typically take so s/he doesn't get caught out by volatile swings. All of this is now being made more difficult with the introduction of new accounting rules on financial instruments and hedging, which increases the work of the corporate treasurer and necessarily requires an increased level of knowledge and understanding. Even if s/he's not an accountant, the corporate treasurer must have a sound understanding and knowledge of tax and accounting issues to determine how best to position the company and how to use the tax and accounting regulations to its best advantage.

The treasurer's responsibility does not end when the day's commercial paper is issued or when the forex requirements are taken care of. The treasurer needs to work with operational areas of the company to understand the business in depth. S/he cannot work in isolation and hope to do an effective job for the company.

It is inevitable that, no matter how good a job the treasurer and his or her staff do, gaps will appear. Mistakes will be made. When this happens, they need to be dealt with. In the course of a highly volatile day like the one discussed above, it would be best if the treasury department could sit on the sidelines and watch the fireworks. If they have work to do, then it's best to get it done as early as possible. If there is commercial paper to be issued, then treasury personnel should know in advance that a busy and potentially volatile day is approaching and try to pre-deal to lock in prices. If they can't do this, then they should try to get as much done as possible before the economic data start to come out.

The same holds true if you are an investor. Get as much done as early as possible. While in the case above an interest-rate investor would have been better off waiting, the situation could easily have been reversed, putting the same investor in a worse position. Hindsight is perfect. We can all look back and say "If I had done this, then . . ." Don't get caught in that game. Do the best you can at the time. It is better to be prudent and miss

out on a few basis points than to be stupid and miss out on a couple of hundred basis points.