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ECONOMIC IMPLICATIONS OF THE STOCK MARKET ROUT

Berenberg Macro Flash

Financial markets are prone to major swings in sentiment: from euphoria, to correction and back again. This is normal. Occasionally, these swings can go a little too far in one direction or the other. When this happens, we have to consider the economic implications. We see three key questions:

Are markets correct to sell-off?
An initial run-of-the-mill sell-off in equity markets that began roughly a week ago seems to have gained significant momentum after US wage growth data came in a little stronger than expected last Friday (2.9% yoy in January vs. expected 2.6%). In a way, the sell-off on this news makes some sense. The Federal Reserve will be keeping a close eye on wage data now the US economy seems to have reached full employment and real GDP is growing above its potential rate. Stronger-than-expected wage data thus tilts the risks towards more, rather than fewer, than the three hikes the Fed is signalling to markets for this year. A steeper path for rate hikes implies higher discount rates for revenues when pricing stocks. However, the current sell-off seems exaggerated relative to the likely pace of monetary tightening.

While we identified US wage inflation a key risk for 2018, especially in light of the upcoming US fiscal stimulus, the 2.9% figure for January is well below the danger zone that would lead the Fed to slam the brakes on the US economy. Instead, the path of stronger wage growth seems consistent with four, rather than three hikes this year by the Fed. This pace should be enough to prevent an overheating while allowing the healthy economic growth to continue. Unless US wage inflation starts pushing the 4% mark, we need not worry too much about Fed suddenly becoming much more eager to take away the punch bowl quickly.

What will be the economic impact?
The modestly higher sovereign yields and expected central bank rates reflect the recent acceleration in growth, they pose no serious threat to it. Equity market sell-offs do not typically show up in economic data much. Scary charts coupled with strong adjectives on the front pages of the newspapers may deter spending a little for a day or two, but as long as the market settles down things should get back to normal quickly. When the rises in asset prices are coupled with excessive gearing, such that the fall in the values of assets exceeds the value of the associated liabilities, this can have strongly negative balance sheet and wealth effects that can matter. But this is not a major risk today. If the sell-off has any effect on the real economy, it could be more pronounced in the US where households hold much more of their wealth in the equity markets than here in Europe. That said, the still easy Fed policy, plus economic reform, and the upcoming fiscal stimulus should far outweigh any negative effects on the US from the market rout.

Should central banks respond?
In short, no. In markets, the loss components is just as important as the profit component. When economic fundamentals are healthy and improving, as they are, the central bank should not show too much eagerness to catch markets on the downside as this risks encouraging the bad behaviour that can have dangerous economic consequences down the line. What the new Fed chair Jerome Powell does, or does not do, in the coming days might set his tone for his tenure. Expect major central banks to do no more than reiterate previous guidance that economic conditions, while improving, still warrant a slow exit from stimulative monetary policies. This should be enough to calm things down a bit. As an aside, if markets began to fear a significant impact on economic momentum, the adjustment to this new expectation would partly act like a self-correction to the initial overshoot. Upon anticipating the hit to economic growth, markets would pre-

dict a slowdown in the pace of monetary policy tightening. This would slow the rise in yields and pace of tightening in financial conditions for the real economy and in markets.

The path to normality may not be smooth: Markets have enjoyed a sweet spot in the past year or so. Strengthening economic data that did not quite prompt central banks into putting on the brakes encouraged an equities rally while keeping sovereign bond yields lower than one would normally expect given the market's expectation for GDP growth and inflation. The rise in bond yields reflects a return to normal for economic growth and inflation. And the softer equity markets, which for now reflects no more than a correction of the little excess on the upside in recent months, need not change the economic or central banking calculus much. The bond and equity moves together reflect the much broader trend of advanced economies and their financial markets returning to the old (pre-Lehman) normal.

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