Market volatility has risen as tighter monetary conditions loom

February was a bumpy month for markets, with volatility rising to its highest levels in over two years. The S&P 500 index is down 5% from peaks after regaining some of its losses. Fears of complacency combined with a changing view on the pace of central bank tightening, particularly in the US, laid the ground for the market retreat since early February. Yields have also climbed as some factored in a more hawkish Fed in 2018. Meanwhile, economic data continued to confirm a robust recovery in the global economy, whose outlook improved on expectations of a more favorable fiscal policy in the US.

Markets see Fed moving faster on rate hikes in 2018

Much of the jittery sentiment has come from the US, where inflation appeared to pick up pace enough for some to expect a more hawkish Fed in 2018. Strong core CPI inflation in January affirmed the solid wage growth data seen earlier. The 0.35% monthly gain in core prices was by far the largest in years. Still, annual inflation was unchanged at 1.8% y/y. (Chart 1.) Producer price inflation also beat expectations with a 0.4% m/m gain. The PCE price index also confirmed stronger price growth, though core inflation was steady (1.5% y/y) and well below the 2% target.

Expectations of more Fed hikes in 2018 are also being fueled by a positive shift in the growth outlook for the US. Already healthy growth is likely to be bolstered by fiscal stimulus in the form of historic tax cuts and higher spending. Despite some weaker economic data in January, the broad evidence continued to reflect strength. Indeed, retail sales and industrial production disappointed expectations in January, while durable goods orders were soft. Still, other data has been robust. The February Philly Fed index beat expectations, coming in at a solid 25.8, while consumer sentiment surprised to the upside.

As a result, many now expect the Fed to move faster on rate hikes in 2018. This view was also supported by recent testimony by the Fed chair Jerome Powell in which he suggested that more hikes could be forthcoming this year. Indeed, more analysts now expect four 25 bps hikes during 2018, though the odds of just three hikes are still higher. Yields have also risen. The 10-year US Treasury yield rose to 2.86%, up around 43 basis points since the start of 2018 (Chart 3).

Eurozone growth remains robust

The economic recovery in the eurozone remains in good shape, despite some softer data. February’s eurozone flash PMI eased to its lowest level in several months, though it remained strong at 57.5. Economic sentiment dipped to 114.1, but was still near 18-year highs. Unemployment also remained at a record low 8.6% in January.

Of course, the key concern in the eurozone continues to be the absence of inflationary momentum. Headline inflation edged lower to 1.2%, though core inflation was encouraging at 1.0%. As a result, few expect the European Central Bank (ECB) to move toward tightening monetary
conditions anytime soon, though the stronger economy suggests the ECB might be closer to that than the inflation data suggests.

In Japan, the economy remained on a firm footing though here too the data has been somewhat softer in recent weeks. Industrial activity slowed from 4.4% y/y in December to 2.7% y/y in January on the back of weaker demand and an inventory build-up. Domestic consumption also remains subdued with retail sales growth slowing more than expected. Despite some concerns of a stronger yen hurting exports, the data has shown otherwise. Indeed, exports have held up quite well.

Oil prices have held up despite a retreat from highs

After rising to 4-year highs in January, oil prices retreated as a result of the market turmoil in February. Nonetheless, prices continued to hold on to levels around $65 chiefly as fundamentals continued to look relatively robust (Chart 5). There may also be some downward pressure due to resurgent oil production in the US, which is expected to add 1.3 million barrels per day of extra output in 2018, or around two-thirds of expected non-OPEC production growth during the year.