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MACROCOSM

Weather? Or Not?

Thursday, February 6, 2014
Donald Luskin

Economic effects of the cold are exaggerated -- and so is the threat from emerging markets.

The new shift in the consensus toward slowdown fears -- a 5% correction in stocks will do that! -- doesn't change the more optimistic outlook we adopted late last summer (see "A Major Upgrade to our Strategic Outlook" September 12, 2013). Our view is premised on the belief that the end of the era of global financial contagion will gradually enable a resurgence of bottom-up capital investment. We've said repeatedly that we haven't seen a real beginning of that in the data yet, and don't expect to until some point in 2014.

- Where is the data to support the idea of a global slowdown?
- We detect lots of selective perception, through eyes made tearful by an apparently unexpected -- yet, in fact, long overdue -- correction in world stock markets. *For example January's world PMI data were a little weak on manufacturing and a little strong on services (just as they were in the US). But because services make up the great majority of economic activity everywhere, on a composite basis, world PMI was higher in January, to a level exceeded only once since August* (please see the table below, from "Data Insights: Global PMI" February 5, 2014).
- At least in the US, it's possible that some of the data has been influenced downward by adverse weather.
- *But we're not urgently interested in picking apart the data, nor excusing it as being due to unusually cold weather.*
- *For us the real question is if the present spell of emerging market volatility, allegedly triggered by Fed tapering, points to financial contagion* (see "I Shall Fear No Taper" January 27, 2014).

We'll get to the emerging markets in a moment. First, let's do something about the weather.

Update to strategic view

US MACRO, EMERGING MARKETS MACRO, EUROPE MACRO: The new consensus for a global economic slowdown is based on selective perception of mixed data, biased by the backdrop of a sharp but long overdue correction in world equity markets. Among the weaker recent data, some could be due to unusually severe weather -- but history shows that weather has little or no impact on overall output growth. More critical is the disturbance in emerging economies' markets and currencies. With the exception of a couple countries facing unique adversities, we see this as a speculative over-reaction. We see it as a test of our thesis that the era of global financial contagion is over. So far so good -- indeed, most…

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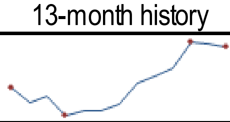
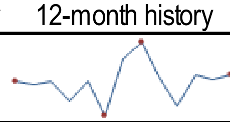
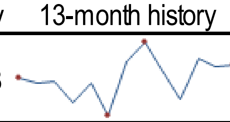
JPMorgan world PMI indices

Manu	Jan14	Prev	13-month history	***Serv***	Jan14	Prev	12-month history	***Comp***	Jan14	Prev	13-month history
Index	52.9	53.0		Index	53.8	53.5		Index	53.9	53.8	

Source: JPMorgan, TrendMacro calculations

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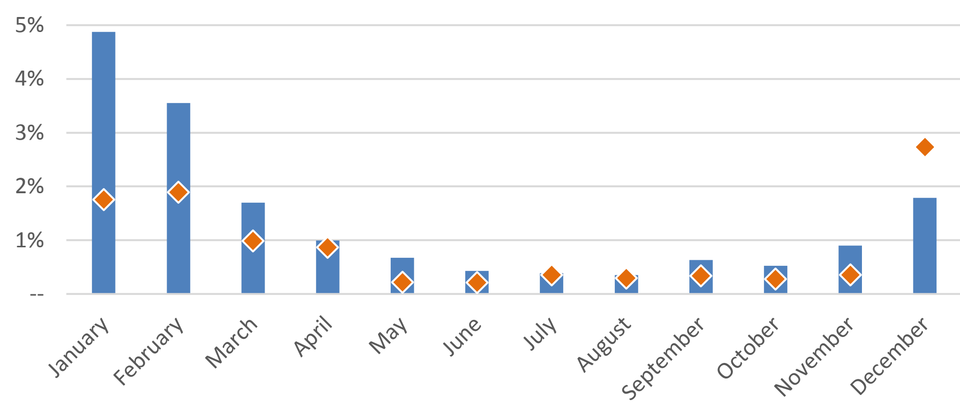
- Unemployment effects from weather are [reasonably well-documented](#).
- But it's been an atypically small factor -- until December (please see the chart below).

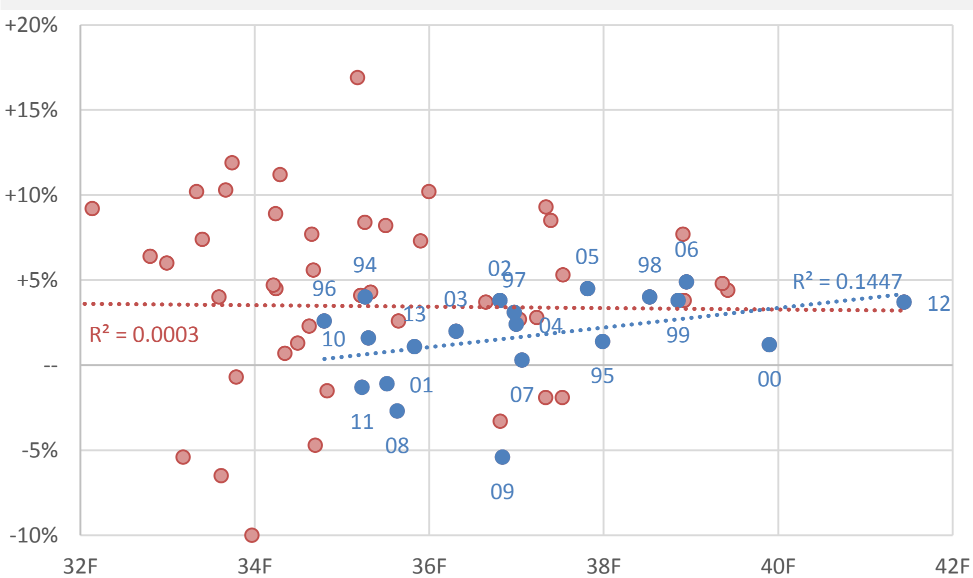
Share of unemployment due to weather ■ Average 1976-2013 ◆ 2013



Source: BLS, TrendMacro calculations

- All year the seasonal adjustments over-adjusted for weather, until in December they under-adjusted. So maybe this does explain the worse-than-expected December jobs report (see ["On the December Jobs Report"](#) January 10, 2014).
- But it's hard to see much of a weather effect on overall output growth. From 1948, there is no correlation at all between Q1 real GDP growth and mean national temperature in the same quarter (please see the chart below).
- But the last 20 years are a little different. They are generally warmer, with no first quarters below 34 degrees -- although 2014

Q1 real GDP growth, SAAR, versus mean US temperature
• From 1948 to 2013 • From 1994 to 2013 --- Linear trends



Source: BEA, National Climactic Data Center, TrendMacro calculations

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… emerging markets are above their lows of last summer, when Fed taper fears first broke out, whether measured in local currencies or US dollars. If there were a systemic threat from the EMs, then peripheral euro area stock and bond markets would be getting hit hard. Instead, they are the best-performing in the world year-to-date.

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February 5, 2014

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may break that pattern (please see again the bottom chart on the previous page).

- And over the last 20 years temperature and real Q1 output growth are somewhat correlated. But the correlation is not strong -- neither overall, nor in the outliers. Despite the "Blizzard of '96" and the snow and ice storms of 1994, growth in those years' first quarters was actually above average (please see again the bottom chart on the previous page).
- The correlation does not increase by looking at freezing precipitation rather than temperature.
- And there is no "bounceback" effect -- that is, there is no correlation between low temperatures in Q1 and faster growth in Q2.
- How can weather matter to jobs and not to output?
- Perhaps it is because adverse weather drives capacity reductions in firms with elastic labor forces -- while increased demand for heating and emergency services just call upon greater capacity utilization of an inelastic labor force.
- *Overall, we are inclined to see this season of adverse weather more as a source of noise than of signal.*
- *Even if it were substantively explanatory, it will be transitory too.*

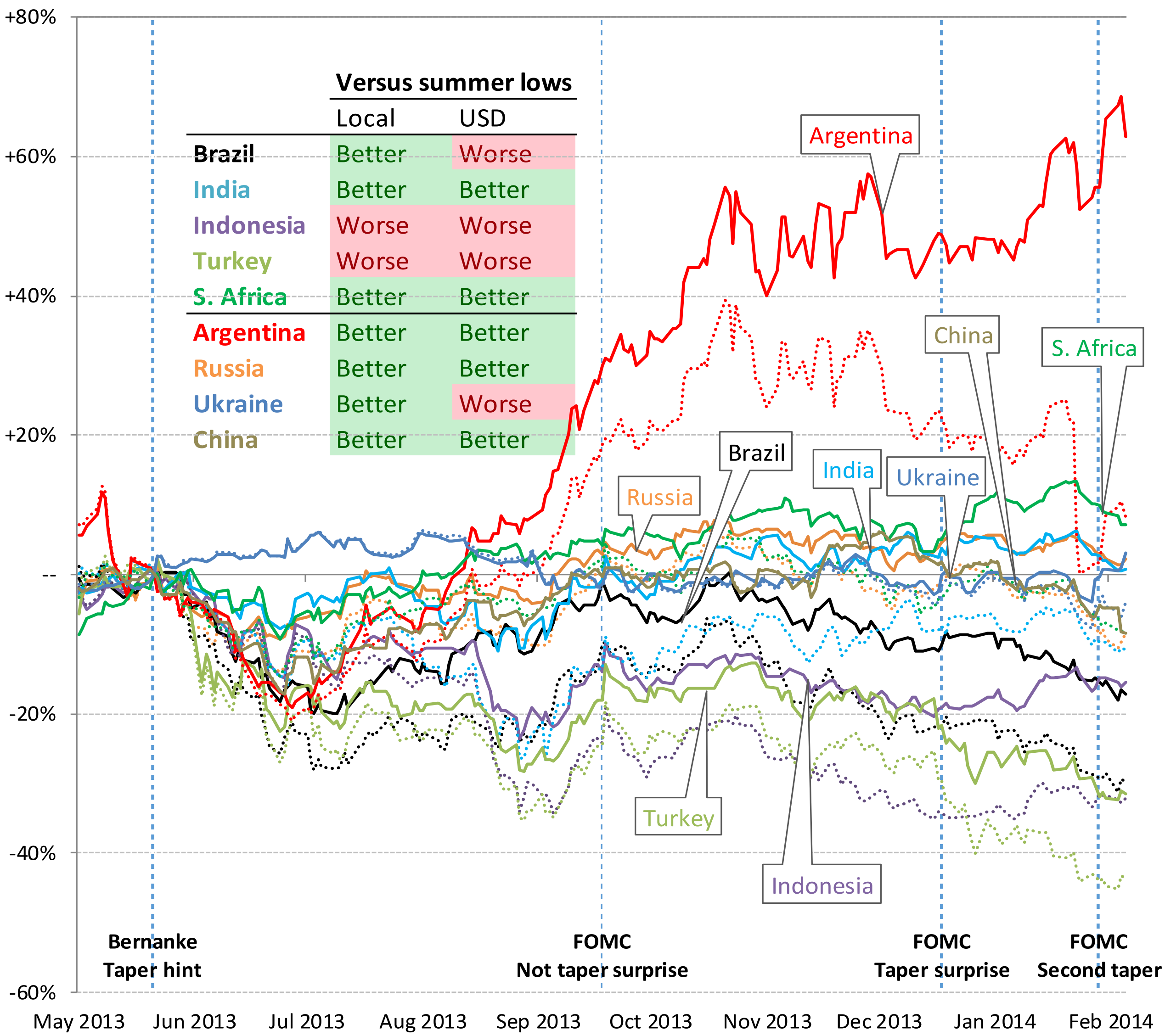
Now on to the volatility in emerging markets.

- No new evidence has caused us to change our initial take last week (see "I Shall Fear No Taper" January 27, 2014).
- Certain emerging nations -- notably Ukraine and Turkey -- are experiencing unique geopolitical stresses. Another -- Argentina -- has deliberately devalued its currency (which should come as a no surprise to a sane person).
- But for the rest, what we've seen is a speculative over-reaction, lofted on the wings of the narrative that Fed tapering is sucking capital out of developing economies regardless of fundamentals.
- This narrative has shown up in some disturbingly high places -- despite the reality that, at this point, no one can point objectively to any reason why the Fed's asset purchases are doing anything at all (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). It was even cited this week by Toyota, to control expectations even as it predicted the most profitable year in its history.
- Such narratives are inevitably self-fulfilling prophecies, to some extent. Indeed, the prophecies fulfilled themselves already last summer right after Fed chair Ben Bernanke first indicated that tapering was on its way (see "QE Steps Down Before Bernanke Does?" May 23, 2013).
- *In June and July of 2013, the same emerging economies that are under stress now underwent sharp corrections in their equity markets and their currencies.*
- *In most cases, emerging equity markets -- whether measured in local currency or in US dollars -- are above their respective lows last summer* (please see the chart on the following page).
- *We think this very obvious fact is not generally recognized --*

__instead, we detect capitulation among emerging markets investors, and fear among other investors that what is mistakenly seen as new lows for emerging markets portends a new risk for the global economy.__

- Last summer's correction in emerging markets was a test. Arguably, it was a test of whether the Fed could taper without pulling the rug out from under the global economy -- we passed that test (see ["A Little Distant Gunfire"]() August 29, 2013). We think it was, more important, a test of the proposition that the era of global financial contagion is over -- that *markets everywhere* can survive disruptions in *a market anywhere*. We passed that test too.
- *The present disruption in emerging markets is another test of the world economy's liberation from financial contagion. __But it is__*

Performance of selected emerging equity markets **— Local currency** **••• USD**
From May 21, 2013, the day before Bernanke's first tapering hint



Source: Bloomberg, TrendMacro calculations *actually only a secondary test -- an attempt to confirm a test already taken and already passed. So far so good.*

- We note with particular satisfaction one piece of evidence that emerging markets volatility is not acting as a source of global contagion -- but rather is only part of a global correction.
- If contagion were a risk, we would be seeing severe reactions in the euro area's most fragile large economies -- yet we are not.
- Political turbulence in Turkey is right on the euro area's frontier. The upheaval in Ukraine risks euro area access to Russian natural gas. And Spain's largest banks have significant revenue and asset exposures to both Argentina and Brazil.
- And yet -- nothing. Indeed, Italy's most vulnerable large economy, Italy, can boast the best-performing major stock market in the world in 2014 -- up 0.5% year-to-date. Spain's stock market is off only 1.4% (by comparison, the S&P 500 is off 5.2%).
- The fragile sovereign bond markets of these two debtor nations have performed well, too. While 7 to 10-year US Treasuries have returned 2.8%, Italian sovereigns have come in close at 2.5%, and Spanish sovereigns have significantly outperformed at 3.9%.
- Nothing in this present global correction -- and nothing in this test of the world economy's robustness to contagion -- has disrupted what we expected for the euro area at year-end: "Peripheral euro area stocks and bonds will be top performers" (see "2013: The Year of Living Not Dangerously" December 31, 2013).
- If the euro area is the developed world's canary in the mineshaft, then we can be comfortable that the present adversity will pass, and that the global economy can emerge more confident than ever.

Bottom line

The new consensus for a global economic slowdown is based on selective perception of mixed data, biased by the backdrop of a sharp but long overdue correction in world equity markets. Among the weaker recent data, some could be due to unusually severe weather -- but history shows that weather has little or no impact on overall output growth. More critical is the disturbance in emerging economies' markets and currencies. With the exception of a couple countries facing unique adversities, we see this as a speculative over-reaction. We see it as a test of our thesis that the era of global financial contagion is over. So far so good -- indeed, most emerging markets are above their lows of last summer, when Fed taper fears first broke out, whether measured in local currencies or US dollars. If there were a systemic threat from the EMs, then peripheral euro area stock and bond markets would be getting hit hard. Instead, they are the best-performing in the world year-to-date.