Employment Report Reactions

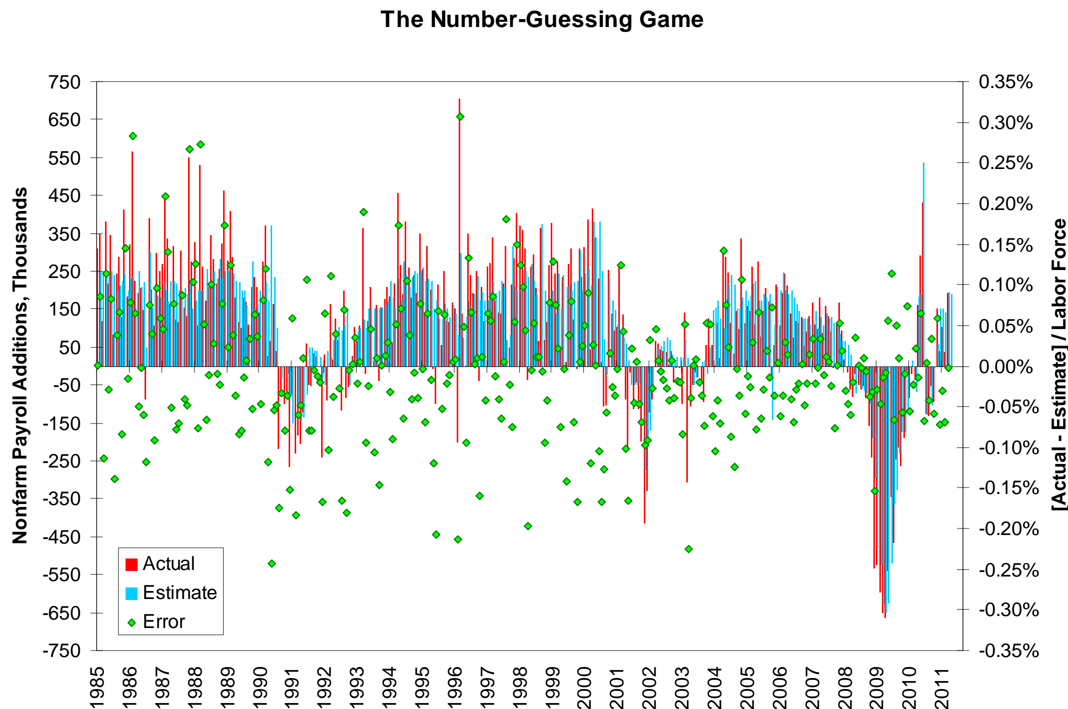
One of the sillier things heard in the world of trading is, "Markets do not like uncertainty." Really; markets get nothing but uncertainty, so if it is certainty you want, you had best find it elsewhere. Within the world of uncertainty you can subdivide the surprises along a two-by-two matrix of whether the timing of the event is known and whether the nature of the event is known.

The monthly employment situation report qualifies as having both a known time and a known nature of the event: Whether you are ready or not, those numbers are going to be thrown in your face at 8:30 AM Eastern Standard time on the first Friday of the month. The nature of the event is known, too: You will get a blizzard of numbers on nonfarm payrolls, the unemployment rate, hourly earnings, etc, along with revisions of the previous month's numbers. Just as military amateurs talk tactics while the professionals talk logistics, fast-trigger traders talk the headline number of the nonfarm payroll additions or subtractions while the professional economists poke around the entrails of the data and look at the nature of the revisions.

In even a not-so-perfect world, the employment situation report would be released at a much later date. It is ludicrous and almost irresponsible to release an economy-wide report replete with statistical estimates knowing major revisions will be forthcoming and knowing it has major financial market impact just days after the reporting month has ended.

Guessing The Number

A major cottage industry of guessing the number using all manner of indicators has arisen over the years, and despite the popular impression economists cannot hit the broadside of a barn with their forecasts, many of these estimates are surprisingly good. Over the past quarter-century, the average forecast error for the first release of payroll additions has been on the order of 83,000 jobs. This is an average error of approximately 0.062% of the labor force and more than "good enough for government work" to which it is related. The forecasts are even better for the revised numbers released during subsequent reporting months, but that is of little interest to the fast-trade crowd.



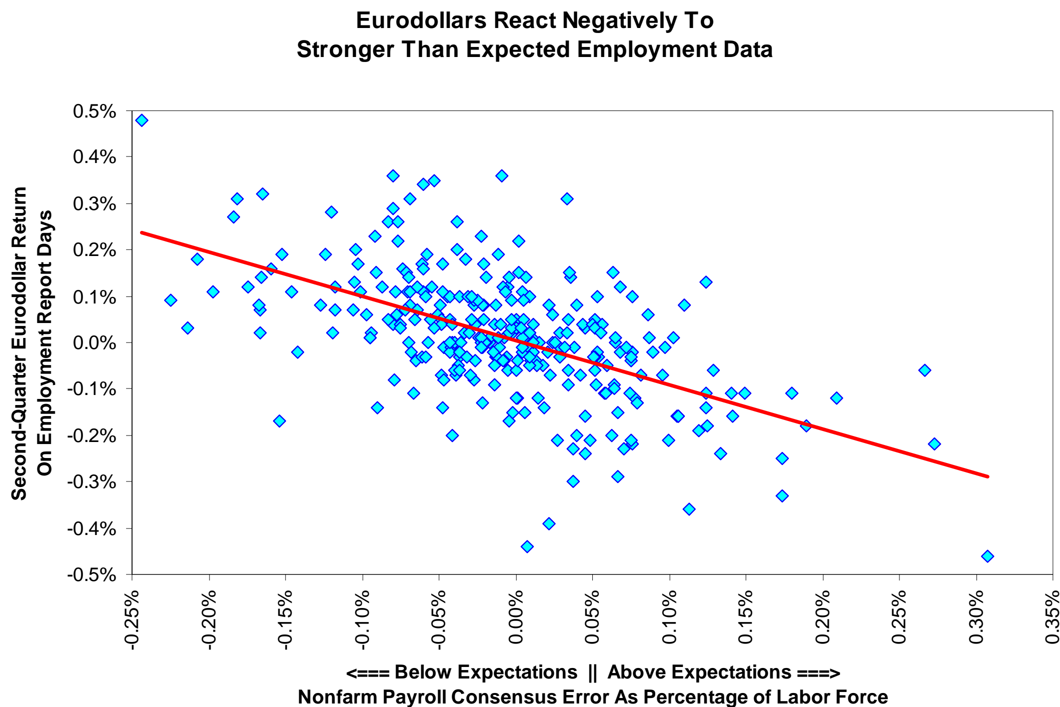
Market Impact

Unless you are involved in one of those over-the-counter bets on economic data – and if you are, why? – your actual interest should not be in the accuracy of any economists' consensus or even in the number itself, but rather in the market reaction to the nonfarm payroll data. The entire basis of the markets' reactions has changed gradually but almost permanently since 2007; previously, it was thought a stronger-than-expected payroll additions number would lead to a tightening of credit by the Federal Reserve. As the central bank apparently has misplaced the operations

manual for anything other than near-zero percent interest rates and excess reserves in the banking system, the notion any policy change will be induced by the employment number has fallen by the wayside.

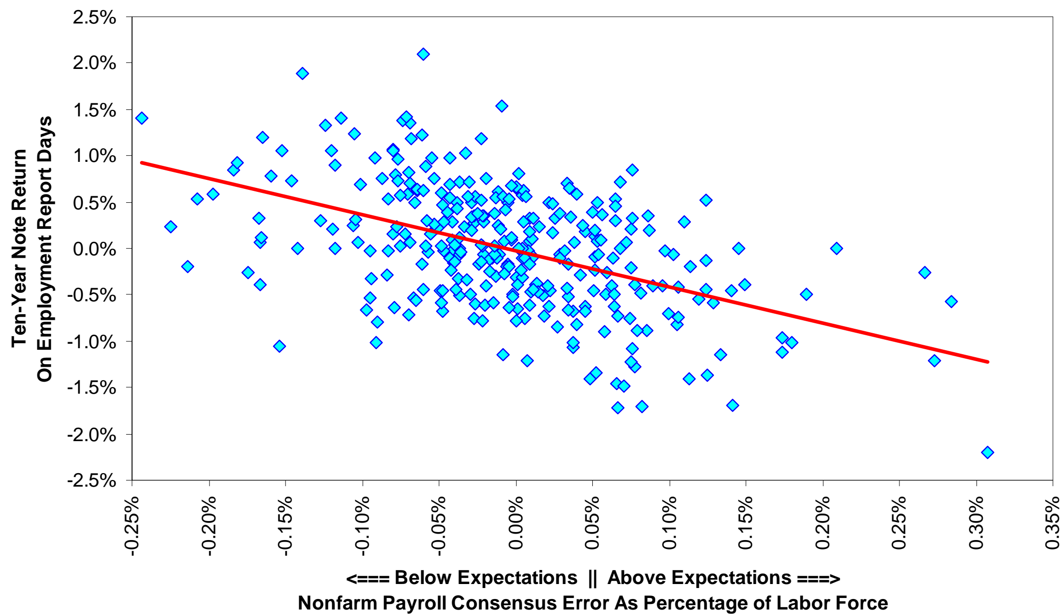
Instead, the markets became focused on employment, known to be a lagging indicator of the economy, and its implications for the continuation of what has been dubbed the Great Recession. You are free to ponder the wisdom of trading forward-looking financial markets off of backward-looking and lagging economic data; even if you decide this concept is nonsensical, however, it is how the markets operate.

Let's take a look at the distribution of daily percentage price changes for four different financial markets as a function of the forecast error for the employment report. The first market is the second-quarter Eurodollar futures contract, the one that should be the most responsive to perceived changes in monetary policy.

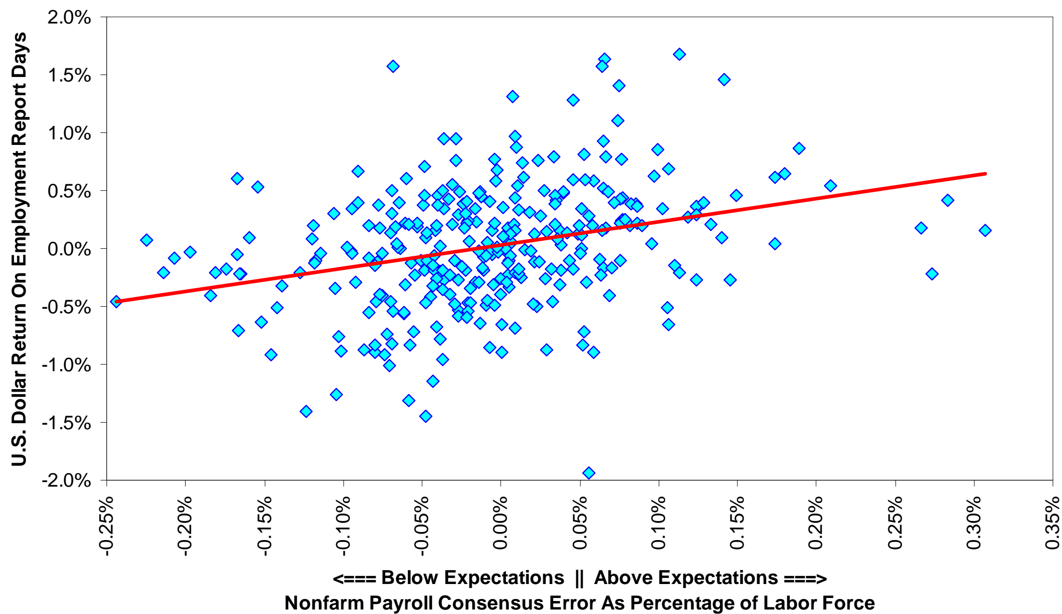


Score one for the conventional wisdom being correct: The relationship between the futures market and the forecast error is strongly negative. Higher-than-expected nonfarm payroll additions do in fact push short-term interest rates higher.

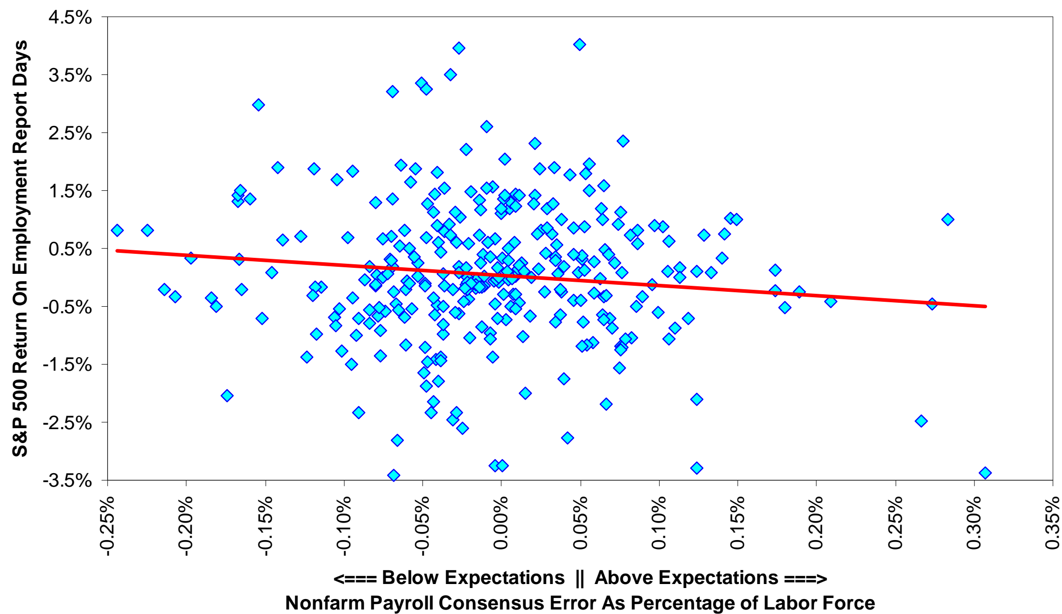
Now let's move on to ten-year Treasury futures. Once again, the conventional wisdom is correct even in the recent absence of an expected change in monetary policy or even in the face of the long-term relationship between employment and interest rates. Ten-year interest rates have been declining since September 1981 even though the U.S. has gone through several periods of strong economic growth, two episodes of higher short-term interest rates and a complete collapse in fiscal responsibility. But come the first Friday every month, you had better be short the ten-year notes if the employment data were stronger than expected.



Now let's move on to the U.S. dollar as measured by *Bloomberg's* correlation-weighted dollar index, a close relative of the Finex dollar index, but less weighted toward the euro during most periods. Reasonable people can argue whether stronger employment data should in fact lead to a stronger dollar – if the prospect becomes an increase in short-term interest rates sufficient to slow U.S. economic growth, overtly strong employment data and higher short-term interest rates could be bearish for the dollar – the market's reaction is unambiguous. The stronger the employment data are, the stronger the dollar becomes on the employment situation report day.



Now let's conclude with the S&P 500. Here the reaction highly ambiguous. The stock market often reacts negatively to the prospect of higher short-term interest rates, and this reaction can outweigh any impulse towards higher earnings. Conversely, the stock market likes the prospect of the Federal Reserve staying away from any rate hikes. The moral of this story is the stock market may talk about earnings and economic growth, but both can take a backseat to free money. This has been and will always be true.



A final lesson can and must be absorbed, and that is one day does not make a market. Throw a boulder into a pond and you will get a big splash, but those waves will disappear quickly. Even the largest employment surprise will not reverse general trends in financial markets all by itself. Worse, the advent of algorithmic trading and its use of elementized news feeds mean much of the reaction to a surprising number is not tradable for all but the fastest traders.

Whether markets like uncertainty or not, you should not like surprises, especially those capable of ruining some nicely held positions. The good news is the employment report, which comes at a known time and affects a known and finite set of indicators. The best way to avoid a surprise is not to put yourself at risk before the report is issued. All problems should have such simple solutions.