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Why Oil, the Fed and Jobs Are Surprising Markets

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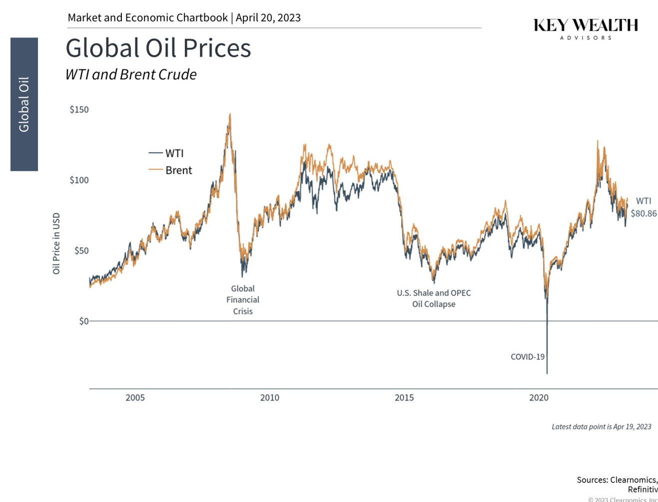
There is an old saying that happiness equals reality minus expectations. This is particularly relevant when it comes to financial planning and investing during times of great uncertainty. For investors, having unrealistic short-term expectations of investment returns and financial outcomes, as many often do in the late stages of bull markets and during asset bubbles, can lead to discouragement. Instead, history shows that by maintaining perspective and focusing on the long run, investors can set appropriate expectations and position themselves to achieve financial goals.

Oil prices are well below recent highs despite surprise OPEC+ cuts



The same is true when it comes to what financial markets expect. By their nature, markets are designed to anticipate future events and assign them a price today. The gap between reality and expectations can drive large market swings, just as they did for inflation and Fed rate hikes over the past year across both stocks and bonds. This divergence has only grown as the Fed nears the end of its rate hike cycle and the economic outlook becomes more uncertain. At the moment, there are three key areas in which the expectations gap is impacting portfolios.

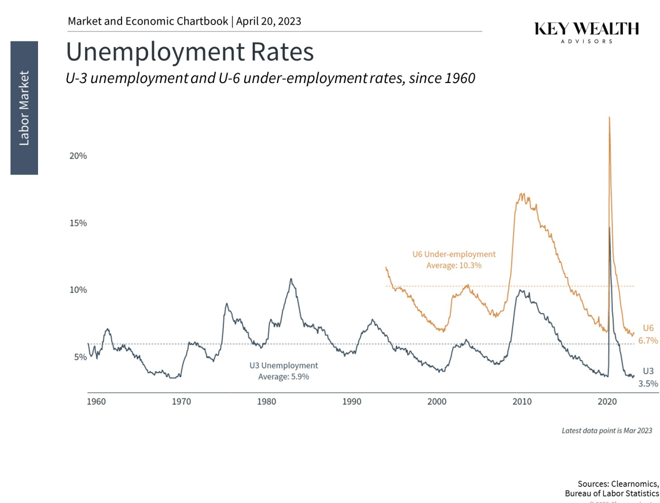
First, OPEC+, a group of oil producing countries and Russia, recently surprised the market when it announced 1.16 million barrels per day (mmpbd) of cuts to oil production starting in May. This is in addition to previously announced cuts, bringing the total to 3.66 mmbpd. Higher oil prices affect the entire global economy since everything depends on the price of energy. One of the primary drivers of inflation last year was Russia's invasion of Ukraine which caused oil

prices to spike above $120 per barrel, increasing gasoline prices at the pump along with other costs to consumers and businesses.

The goal of these production cuts is to prop up oil prices which have been steadily declining. However, it's important to maintain perspective around this announcement. The relevance of OPEC as a price-setting cartel has declined over the past decade, partly because cuts by each country are voluntary and difficult to enforce, and because the U.S. has become the top producer of oil in the world. In Europe, warmer weather and government policies discouraging excessive energy use have helped to reduce its sensitivity to energy prices as well.

Despite the immediate jump in oil prices, both Brent and WTI remain well below their recent peaks. At around $85 and $80 per barrel, respectively, prices are back to where they stood in early March, and are still within their ranges over the past six months. So far, there is little reason to believe that oil prices at these levels will result in another spike in gasoline prices for consumers or in higher inflation measures.

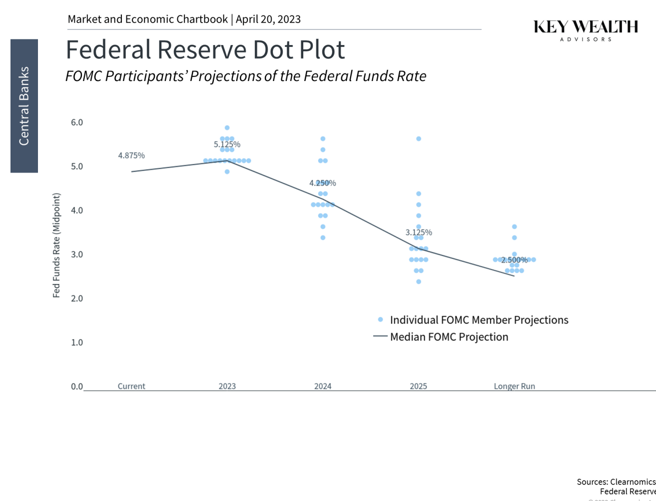
Unemployment remains near historic lows



Second, last week's healthy jobs report also impacted investor expectations on the economy. The report showed that 236,000 jobs were added in March, a pace that is slower than the previous month but that still brings the 6-month average to 334,000 per month. The unemployment rate also fell back to 3.5%, once again near its historic low. Areas such as construction lost 9,000 jobs while leisure and hospitality continued to recover with 72,000 payrolls added.

These particular figures were right in line with what economists had expected. However, the overall strength of the job market continues to be at odds with what many investors and economists believed would occur as the Fed raises rates. The job market is slowing, but not at the pace that would be consistent with such a significant tightening of financial conditions or with a possible recession. The only exceptions to this gradual pace are in the tech sector, which lost 33,000 jobs in January and February but gained 6,000 in March, and the decline in job openings. According to the separate JOLTS report, openings fell below 10 million in February, the lowest level in almost two years.

The Fed and markets disagree on the path of policy rates



Finally, at only 3.5%, the unemployment rate remains well below the Fed's projection of 4.5% at the end of this year. This is one reason that some expect the Fed to continue raising rates, or at the very least to keep them higher for longer. The Fed's own forecasts imply that it will raise rates by another 25 basis points and keep them steady through year end. After all, the Fed has prioritized fighting inflation which remains much higher than they would like.

This is a significant divergence from what is implied by fed funds futures today. These market-based expectations suggest that the Fed could begin cutting rates by September and continue doing so into 2024. Thus, there is a big expectations gap between what the Fed is saying is appropriate and what the market believes could occur. This could drive market swings in the coming months just as it did throughout 2022.

It's important to keep in mind that these market-based expectations are highly volatile and have shifted on a day-to-day basis over the past month in response to the banking crisis. It's also true that sometimes the Fed shifts toward the market, and sometimes the market adjusts to meet the Fed. Early last year, for instance, the market expected the Fed to change its course to fight inflation, which is exactly what the Fed did. However, markets also expected later in the year for the Fed to begin easing due to improving inflation. When this didn't occur and inflation worsened, markets fell back into bear market territory. Thus, it's important to maintain a longer-term perspective and not react to every market move.

The bottom line? There are a few key areas where market expectations have diverged from reality. Investors should stay focused on their long-term investment and financial plans with an understanding that missed expectations could drive volatility in the coming months.

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