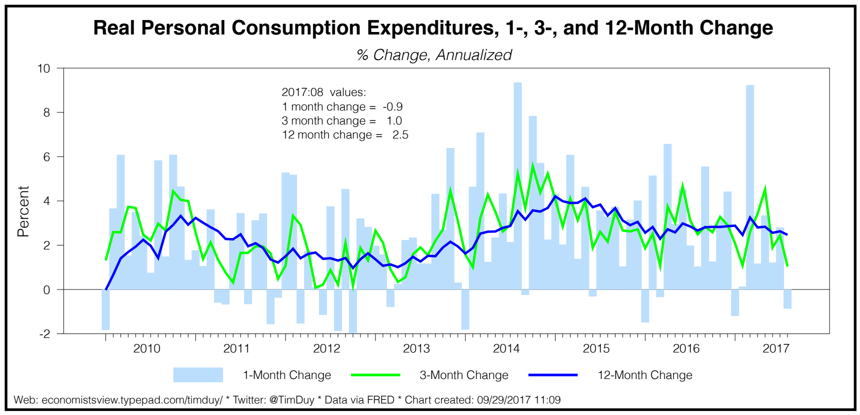
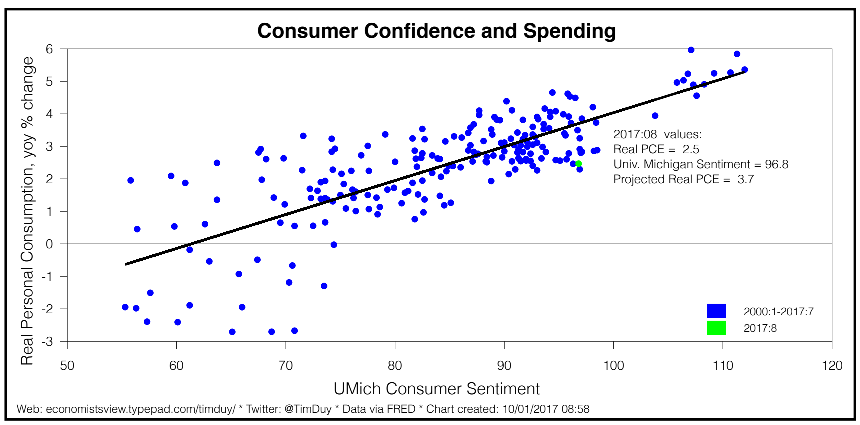
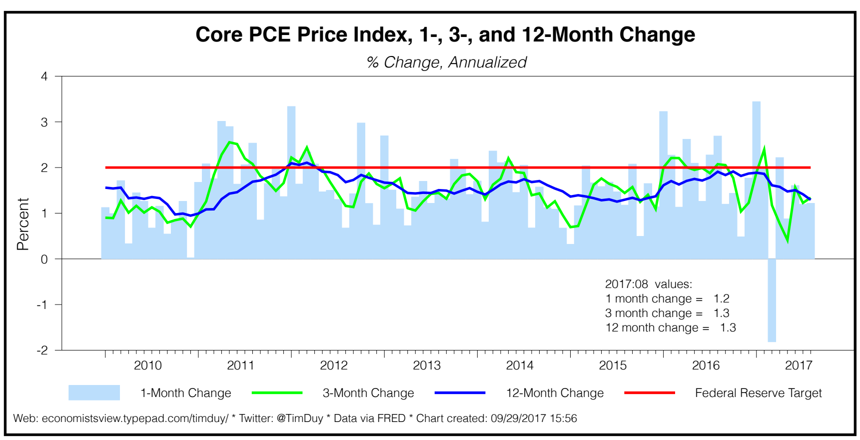
Fed Poised To Downplay Weak Data

Big data week ahead that ends with the employment report for September. Considering the ongoing inflation weakness, one would think the Fed would be looking for a series of very strong job reports to justify a rate hike in December. But with Fed officials largely convinced that the soft inflation numbers are transitory, a middling jobs report would likely be sufficient to keep them on track, and even a weak report if they can attribute disappointing data to the busy hurricane season.





The personal income and outlays report for August, released last Friday, came in on the weak side, with a decline in real consumer spending during the month. Hurricane related? Almost certainly in part, although the Bureau of Economic Analysis is not able to provide an estimate of the impact. Note that despite the monthly gyrations, the underlying trend of consumer spending has been consistently near 2.5% year-over-year since the beginning of 2016. The post-election confidence bump did not pump up spending, which remains soft in comparison to consumer sentiment. Survey respondents simply didn't put any money forward to support their convictions.



Remember that August bounce in core-CPI inflation? It didn't follow through to PCE as expected (the housing component that helped drove the CPI number has a smaller weight in the PCE index). The Fed probably already guessed this would be the case. Still, it is another blow to their predictions that soft inflation numbers this year are temporary. Core-PCE inflation stood at 1.3% over the past year, equivalent to the annualized three month change.

All else equal, ongoing weak inflation numbers should cause Fed officials to lose their appetite for a December rate hike. For example, last Friday Philadelphia President Patrick Harker said that while he retains a December rate hike in his outlook, "inflation is the one area" that "gives me pause."

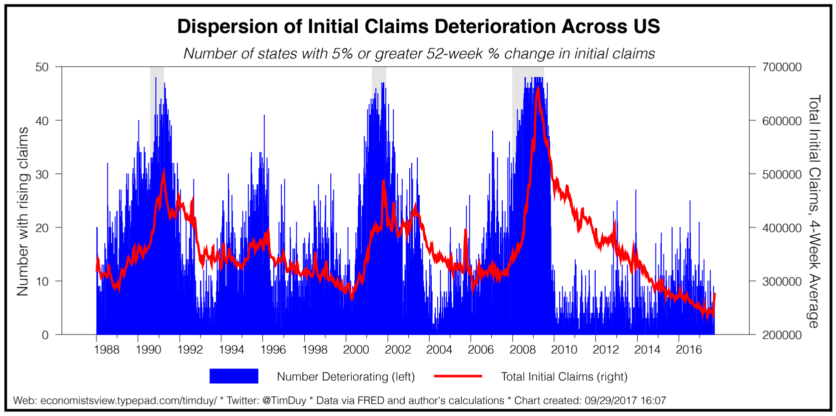
But not all else is equal. Nearly full employment continues to weigh more heavily than weak inflation in the Fed's deliberation. And the Fed expects the labor markets will only continue to tighten over the next year. The Fed believes that employment gains of around 100k per month will prove sufficient to put downward pressure on the unemployment rate; the average monthly gain for the past three months is 185k.

If this pace of job gains continues through the end of the year and does not look likely to slow to 100k in early 2018, the Fed will tend toward maintaining the current pace of rate hikes (three in each 2017 and 2018) despite weak inflation. This is especially true if the unemployment rate does fall as expected. As long as the economy looks as if it is poised to push past full employment, they will see waiting for 2% inflation before raising rates further as the very definition of falling behind the curve.

To be sure, the hurricane season may induce some weakness in the employment report; initial unemployment claims have, as expected, popped up. **No wonder that the consensus estimate for September employment is a gain of just 95k.** But the Fed has already made clear they will look through any hurricane-induced weakness in the data. From the most recent FOMC statement:

> *Hurricanes Harvey, Irma, and Maria have devastated many communities, inflicting severe hardship. Storm-related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term.*

Looking ahead to the week, we will get plenty of data to chew on. This morning we receive the Institute of Supply Management manufacturing report; regional surveys have tended to the strong side, suggesting that the national numbers will be solid. Also on tap this week are vehicle sales (Tuesday), the ADP employment and the ISM services sector reports (Wednesday), and the international trade report (Thursday). There is also a bevy of Fed speakers, including Chair Janet Yellen (Wednesday), but the topics and venues do not look likely to generate market moving news.



Still, Bostic (Atlanta), Rosengren (Boston), Dudley (New York), Kaplan (Texas), and Bullard (St. Louis) all speak Friday after the employment report. Watch Dudley in particular.

Bottom Line: In effect, the Fed is playing a game of "heads I win, tails you lose" with the data. They appear inclined to view middling data as a temporary inconvenience. My instinct at the moment is that soft inflation data, if sustained, is more likely to impact the 2018 rate projections than take the December hike off the table.

In other news, the White House is closing in on a candidate to replace Yellen when her term ends in February. President Trump held some interviews this week. Via Bloomberg:

> *Trump and Treasury Secretary Steven Mnuchin met Thursday with former Federal Reserve governor Kevin Warsh to discuss the job, two administration officials said. Trump and Mnuchin also interviewed Federal Reserve governor Jerome Powell on Wednesday, a White House official said.*

If we can't keep Yellen, Powell is the next best candidate among the names under consideration. On Powell's odds and background:

> *Powell had been regarded as a long-shot candidate, but not out of the running for Fed chair. The only Republican currently on the Board of Governors, Powell, 64, has a solid reputation among lawmakers from both parties and has ably led the Fed's regulatory efforts, albeit on a temporary basis, since Daniel Tarullo retired in April. Before joining the Fed, Powell spent eight years at private equity firm Carlyle Group. He also served as a senior official at the U.S. Treasury under President George H. W. Bush.*

For some thoughts on Warsh, see me here and Sam Bell here. Neither of us are fans.

TIMOTHY A. DUY
PROFESSOR OF PRACTICE
OREGON ECONOMIC FORUM, SENIOR DIRECTOR
DEPARTMENT OF ECONOMICS
UNIVERSITY OF OREGON

Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index. Tim has published in the Journal of Economics and Business and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog and "influential," the Huffington Post identified him has one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

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duy@uoregon.edu

541-346-4660

@TimDuy

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