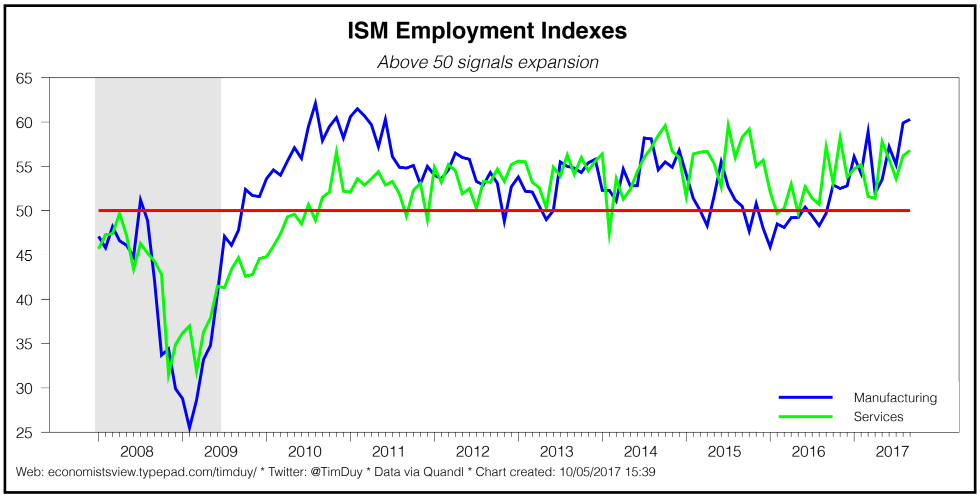
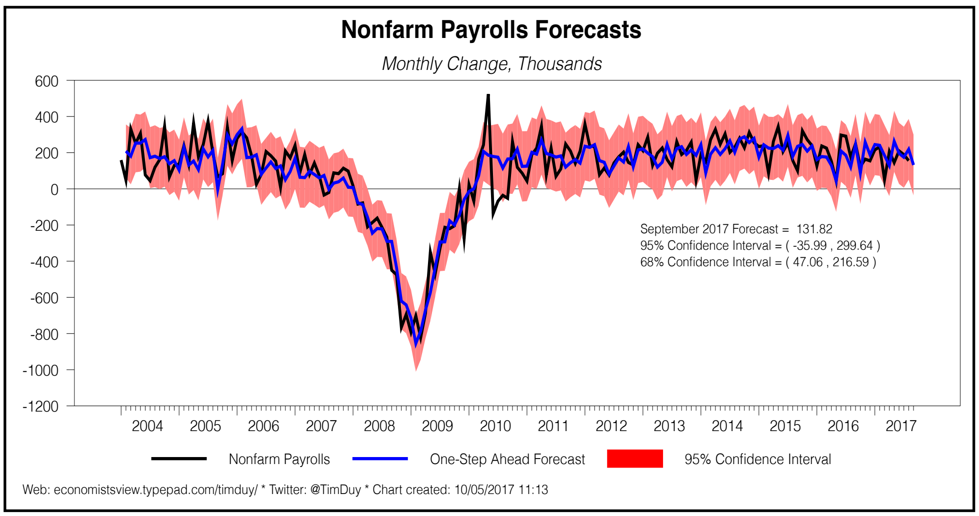
Tim Duy's Fed Watch

OCTOBER 6, 2017

Employment Report Expected to Disappoint

The employment report for September will be released this morning. It is widely expected to disappoint as it comes in the wake of a tough hurricane season. But those weak numbers are not expected to dissuade the Fed from hiking in December. And unexpectedly strong numbers would only help prod along those officials getting cold feet from the weak inflation data.





Early signals on employment have been mixed. The ADP report came in at a 135k gain for private nonfarm payrolls. And, perhaps little noticed, the employment components rose of both ISM manufacturing and service reports. Jobless claims, however, rose. Altogether, applying these factors to my model yields a payroll gain of 132k, on the high side of the consensus range of 0 to 140k (consensus is currently 100k).

Given the uncertainty surrounding this number, however, I would anticipate a number on the soft side of my model's estimate. Moreover, we can expect fairly significant revisions next month. So overall we likely won't be able to read much into the report, and will need to look forward to the October and November reports to accurately gauge the underlying pace of the labor market.

A strong report – high payroll growth, an unemployment rate decline, and faster wage growth – would be a surprise to both market participants and the Fed. The Fed is ready to dismiss a weak number; they will eagerly embrace a strong number to hike rates.

San Francisco Federal Reserve President John Williams spoke Thursday, reiterating his support for additional rate hikes. On inflation, he dismissed the recent soft numbers as transitory, arguing that his staff:

> *...found that inflation rates for prices that tend to be sensitive to the state of the economy have moved back up to around pre-recession levels as the economy has recovered. So, no mystery there.*

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> *But, they also found that inflation rates for other categories that tend to be less sensitive to the economy had fallen a lot and have remained very low... In the past, such sharp price movements in these industries have proven to have a temporary effect on inflation, and I don't expect them to last this time either.*

Combined with an unemployment rate below that consistent with full employment and steady growth, he expects the Fed will need to continue to raise rates. He will be looking for a December rate hike. And note that Williams is a voting member of the FOMC next year, so his relative hawkishness may be amplified.

Williams also turns his attention to the yield curve. Specifically, how the spread between short- and long-term interest rates impacts bank profitability. While he expects that long-term rates will rise as the Fed unwinds its balance sheet (maybe by as much as 100bp), he does not expect spreads going forward to be as wide as in the past:

> *...there are reasons to believe that the spread between short and long-term rates will not return to levels we saw in the past. For one, these large spreads occurred during an extended period when interest rates were falling. This downward trend may have artificially widened spreads.*

He forecasts that the yield spread going forward might be just 100bp, compared to 150bp in the past, with negative implications for bank profitability.

In other news, Randal Quarles was confirmed by the Senate as governor and vice chair of financial supervision. It is anticipated that he will leave a mark by helping ease some of the post-crisis regulatory weight on the financial sector.

Bottom Line: We might not learn much about the economy from today's labor report as it is expected to be muddled by the hurricane activity. But the lack of new information on this front will not yet deter the Fed in their quest to hike rates again this year.

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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 as "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*.

Notice: This newsletter is commentary, not investment advice.

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