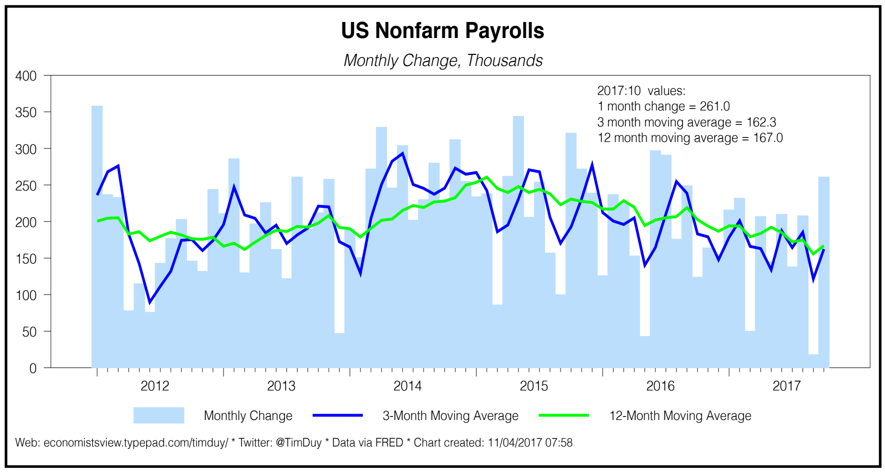
Tim Duy's Fed Watch

NOVEMBER 6, 2017

Fed Will Keep the Rate Hikes Coming

Lots of news from last week, most of which supported the Fed's current anticipated rate path of one 25bp hike in December followed by three more in 2018. The only potential obstacle on that path is the persistent weakness of inflation. **But the ongoing decline in the unemployment rate, along with the promise of further declines in the months ahead, will dominate lingering concerns at the Fed regarding the inflation numbers.**



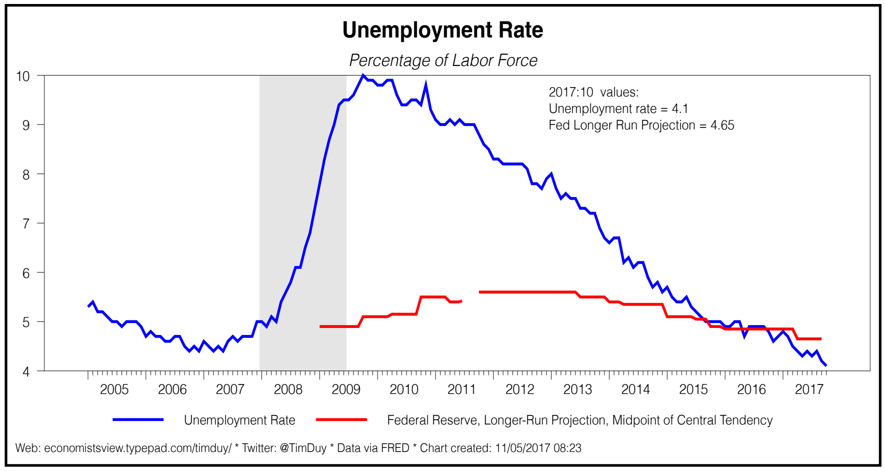
Before digging into the employment report, a reminder that the responsibility of leading the Fed will soon fall to current Federal Reserve Governor Jerome Powell. Last week President Trump nominated Powell to be chair of the Fed after current Chair Janet Yellen's term expires in February of next year. Although I have long believed that Yellen would not be retained as chair, I am still disappointed that she lost the position. Yellen was the most experienced candidate for the job. Moreover, not reappointing her breaks a long tradition of presidents retaining the Fed leadership instituted during the previous administration, regardless of party affiliation. But this administration's strong desire to remove as many vestiges of the Obama years as possible ultimately doomed Yellen's chances.

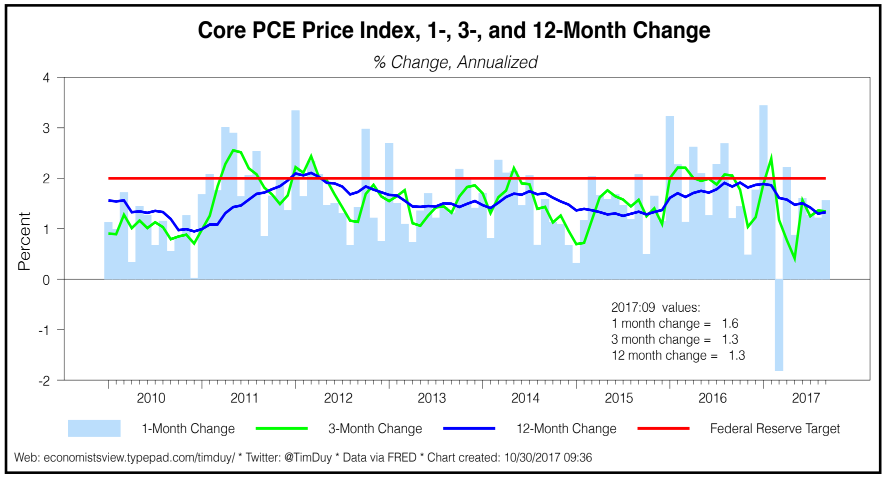
All that said, if Yellen had to go, Powell is an excellent choice to take her position, and I don't want to detract from his success. He is the most likely of the non-Yellen candidates to retain the basic framework under which the Fed currently operates – a framework that has been fairly successful. And, as far as we can tell from the editorials authored by the other candidates, the candidate least likely to be wed to an ideological position on the appropriate stance of monetary policy. I think the ability to remain flexible will be important as the Fed navigates this more mature stage of the business cycle.

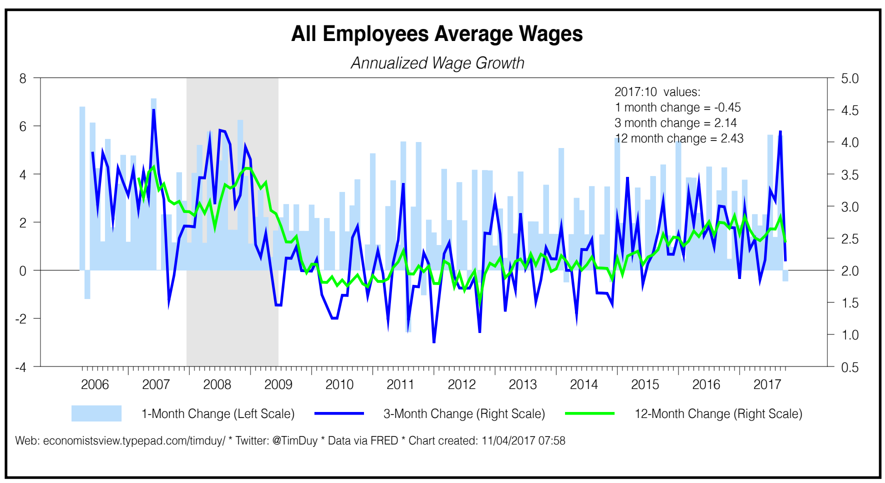
Yellen could remain on the Board as a governor. But will she? The last chair to do so was Mariner Eccles, so she would not technically be breaking new ground. I suspect, however, that Yellen would hesitate to remain if she believed that doing so created a conflict with her successor; she would not want to be seen as someone attempting to usurp the chair's authority. Hence, I tend to think that she will leave unless Powell strongly encourages her to stay.

The October employment report came in strong, rebounding from the hurricane-induced weakness of September. Nonfarm payrolls rose 261k while the previous month was revised sharply upward from -33k to 18k. The underlying pace of job growth – currently 167k per month – remains on a downward trend, but at an ever so slight rate of decline. Note also that the consistent, solid gains in temporary help services suggests that despite the gradual softening in the pace of job gains, the overall trajectory looks to remain upward.

Importantly, the pace of job growth remains sufficient to drive the unemployment rate lower. The unemployment rate fell to 4.1%, well below the Fed's estimate of the longer run unemployment rate. To be sure, a fall in the labor force participation rate helped support the fall in the unemployment rate, but note the overall pattern of labor force participation is really just moving mostly sideways. This already is as good as the Fed might hope; the Fed expects demographic forces to weigh on labor force participation over time. The Fed anticipates job growth will slow to something closer to 100k per month before those demographic forces gather more strength in the data. If job growth does not slow by that time, the unemployment rate could make sharper downward moves.







The unemployment rate is now further below the Fed's prediction of 4.3% for the end of this year. In fact, it is currently at the Fed's prediction for the end of 2018. The Fed's unemployment forecast was always suspect in my opinion. It never seemed consistent with the growth forecast, which, being above the growth of potential GDP would be likely to support greater unemployment declines than predicted. Indeed, I even argued earlier in the year that the unemployment forecasts were almost reverse-engineered to support an overall forecast consistent with a general path of tightening.

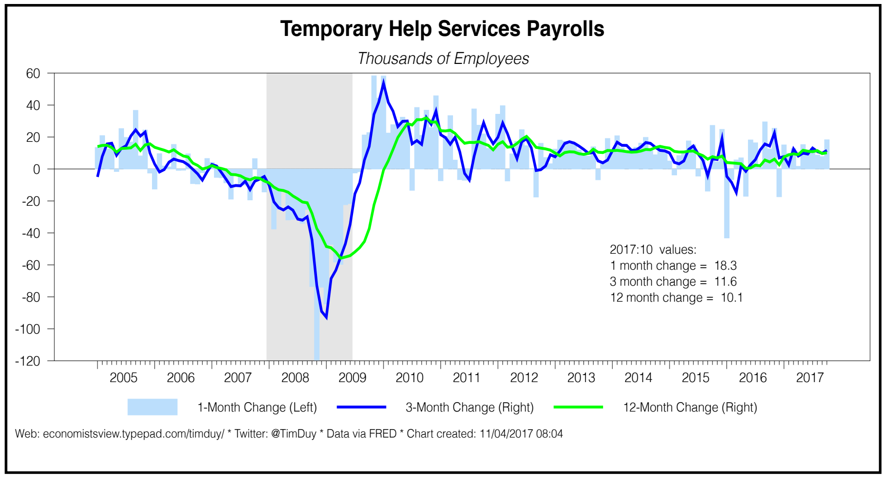
Luckily for the Fed, the surprise inflation weakness matched the unexpected downward move of unemployment such that central bankers would not be pressured to raise rates more quickly. Indeed, persistently weak inflation would arguably call for the Fed to put a hold on the December rate hike. And last week's numbers don't give much hope of an immediate upturn of inflation.

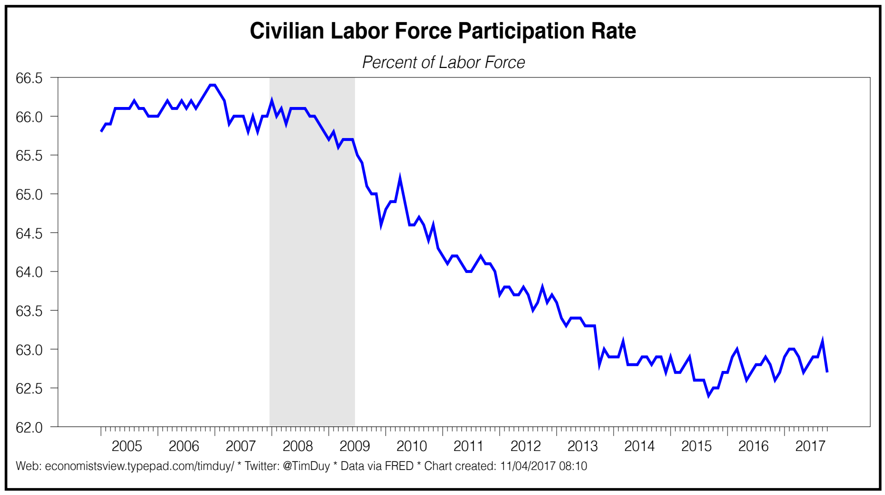
Early in the week arrived another soft core PCE inflation reading. Midweek saw an ECI report for the third quarter; while wages and salary gains are slowly improving, the pace remains fairly subdued. And the wage numbers in the employment report reveal that the fourth quarter got off to a slow start. Average wages growth turned negative, undermining the gains of recent months. Some softness might have been expected given a reversion of some of the compositional changes last month (the decline in leisure and hospitality employment), but the magnitude of the reported decline is disappointing. Perhaps revisions will help.

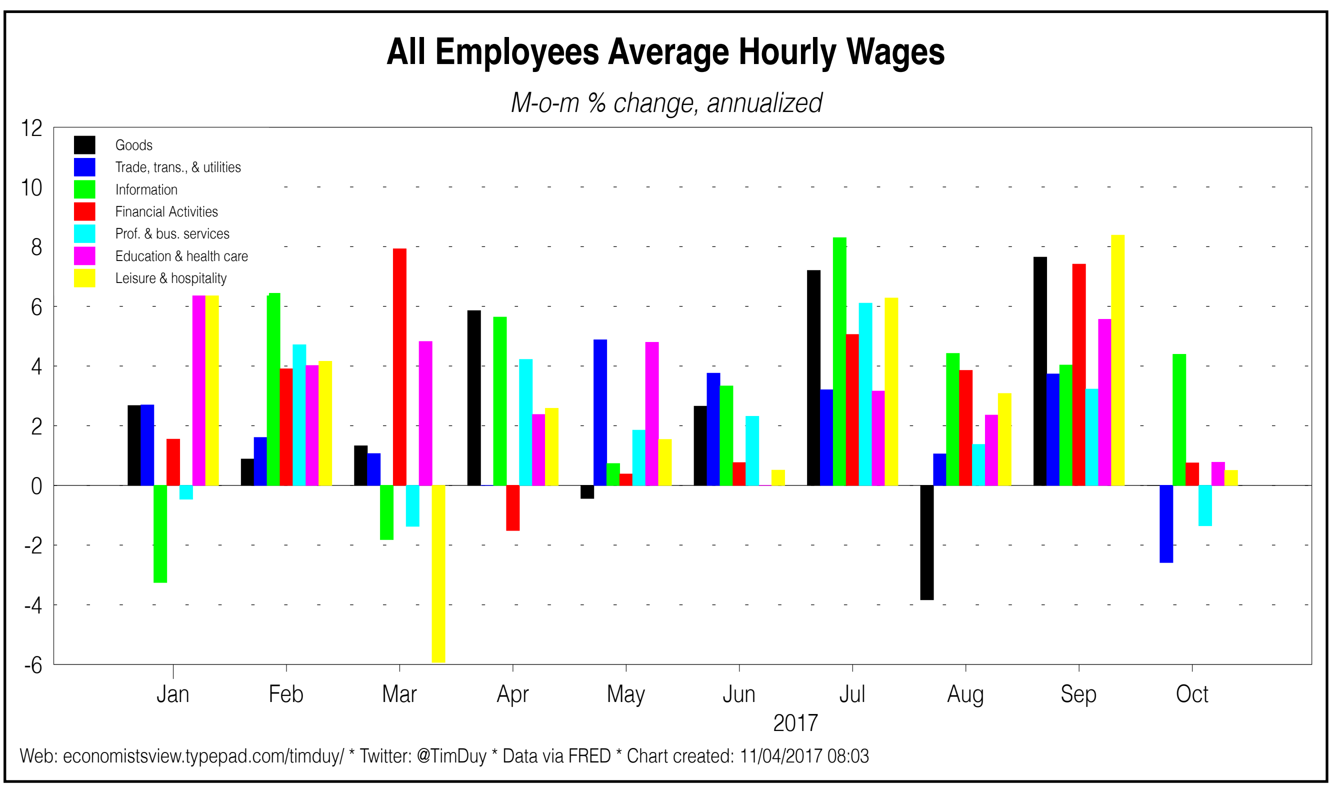
The combination of weak inflation and wage growth and low unemployment continues to pose a problem for the Fed. And, arguably, that problem only intensifies with this employment report. It seems fairly clear that the unemployment rate is heading to something below 4%, possibly by the beginning of 2018. I doubt that the crew on Constitution Ave. will see such a number as anywhere consistent with full employment. Policymakers will become increasingly concerned about growing wage and inflation pressures. These pressures will only become evident with a lag, and given how low the unemployment rate has fallen, may burst out more aggressively than currently forecast. They want to be ahead of any such break in the dam.

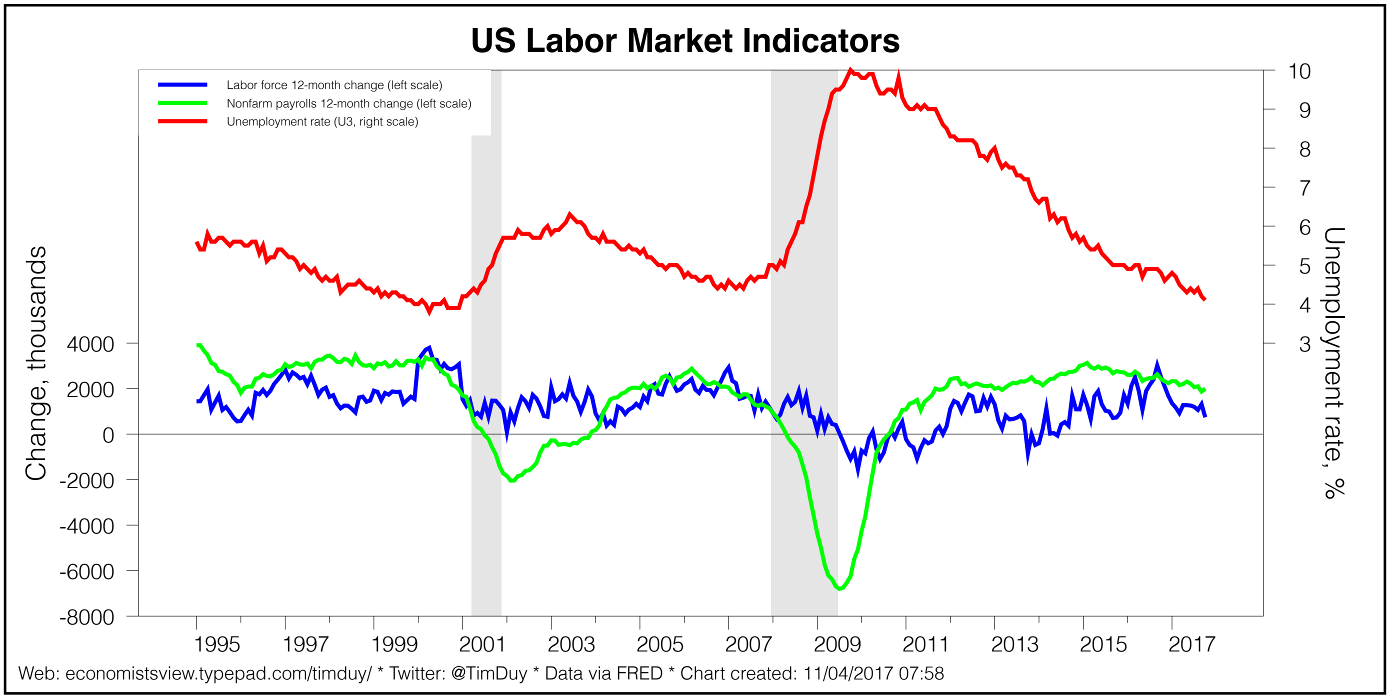
My concern is that if they take the unemployment forecast for 2018 down substantially, which I think likely, while retaining the inflation forecast, they will need to raise the interest rate projections for 2018. To be sure, they might lower the estimates of the natural rate of unemployment or the neutral rate of interest, thus setting the stage for a forecast that retains the existing 2018 rate forecast. But I don't see the latter as likely. And the former is fraught with risks. How low on their natural rate estimates can they safely go? Are they really going to make a big move when they fundamentally believe that transitory factors account for the inflation weakness?

Bottom Line: The economy is humming along fast enough to keep up the downward pressure on the unemployment rate. So far, low inflation has allowed the Fed to discount concerns that the labor market was moving past full employment. Indeed, it seemed that the Fed could lower their rate forecast given the low inflation numbers. But that will all change as the threat of a sub-4% unemployment rate comes into focus. There will be pressure to raise the rate forecast under these circumstances. That pressure will intensify if the transitory factors the Fed believes weigh on inflation suddenly lift.









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

oregon economic forum

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.

duy@uoregon.edu

541-346-4660

@TimDuy

COLLEGE OF ARTS + SCIENCES

ECON Economics

UNIVERSITY OF OREGON