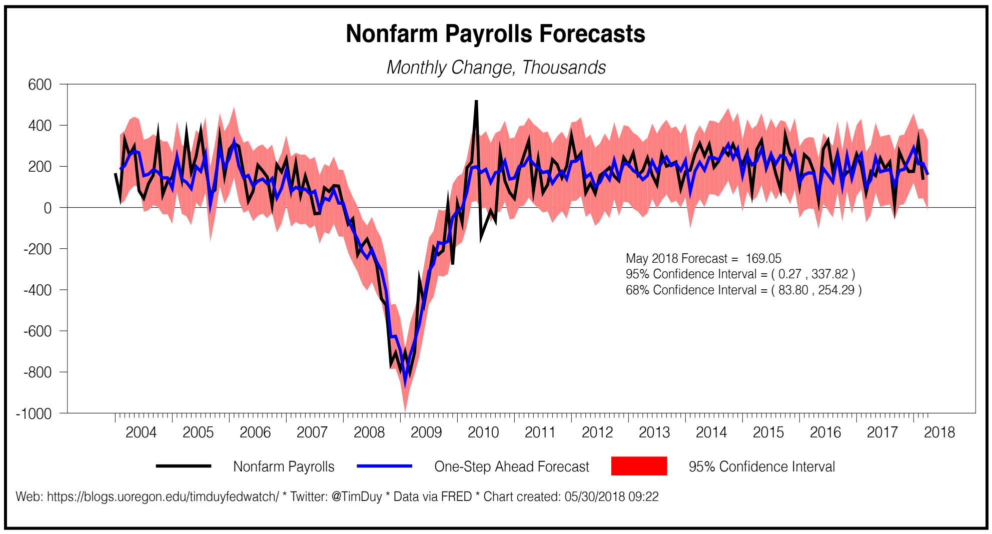
Employment Report Will Keep Fed On Track For June Hike



The May employment report will likely follow in the path of recent data and support the Fed's case for further gradual rate hikes**. Central bankers will pull the trigger on another rate hike at their June meeting. I suspect they will do the same in September as well.** By that point, they will be closing in on the bottom range of estimates for the neutral rate. They will proceed more cautiously thereafter.

Wall Street expects May payroll growth of 190k within a range of 155k to 220k. My model anticipates 167k, pretty much the same as April's unrevised number. That said, instinct tell me that my model is coming in a little light (previous months were weighted down by weather, leaving room for a bounce in May). Consequently, I wouldn't bet against the consensus this month. **Most important though is that anything in the consensus range will confirm the Fed's belief that the labor market holds strong even as the expansion approaches its nine-year anniversary.**

Per usual, watch the unemployment rate, which edged down to 3.9% last month. Employment growth has tended to outpace labor force growth, which should over time place further downward pressure on the unemployment rate. And according to the latest Beige book, labor conditions are getting very tight:

> *Labor market conditions remained tight across the country, and contacts continued to report difficulty filling positions across skill levels. Shortages of qualified workers were reported in various specialized trades and occupations, including truck drivers, sales personnel, carpenters, electricians, painters, and information technology professionals. Many firms responded to talent shortages by increasing wages as well as the generosity of their compensation packages.*

Still, it's not tight until we see broad-based increases in wages, which remain elusive:

> *In the aggregate, however, wage increases remained modest in most Districts.*

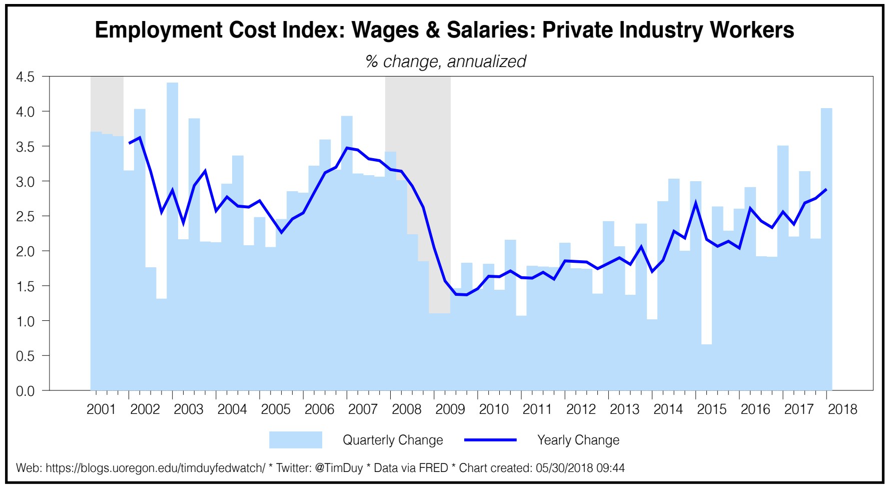
Hope springs eternal though:

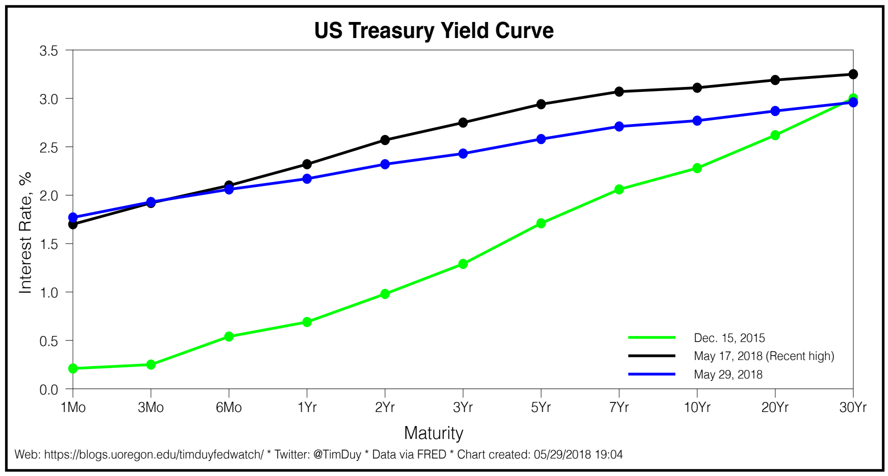
> *Contacts in some Districts expected similar employment and wage gains in the coming months.*

Wage growth is as important as the unemployment rate as the former will confirm or deny the latter's proximity to full employment. Wage growth has been notoriously low, and is expected to remain to with a gain similar to April's number. A faster gain (note that the Employment Cost Index has looked healthier in recent quarters) would help confirm the Fed's estimate of the natural rate of unemployment (4.5%).

That said, wage growth acceleration alone will not prompt the Fed to take a more hawkish stance. They really need faster wages gains combined with more evidence that inflation will consistently overshoot target (by something greater than a modest overshoot) to justify accelerating the pace of rate hikes. The Beige Book again gives some hints that inflation might pick up in the months ahead:

> *Prices rose moderately in most Districts, while the remainder reported slight or modest increases. There were several reports of rising materials costs, notably for steel, aluminum, oil, oil derivatives, lumber, and cement. A few Districts noted that these reports of rising materials costs were becoming more common across contacts. Input cost increases, along with labor shortages in some sectors and strengthening demand, put upward pressure on prices in the transportation, construction, and manufacturing sectors. Some Districts also noted that their retail contacts were more able to pass along price increases to their customers than in the recent past.*





But, again, anecdotes and data are two different things. The anecdotes will keep the Fed on the gradual path, but it will take data before the Fed shifts gears to something else.

The Beige Book upgraded the overall assessment of the economy from this in April:

> *Economic activity continued to expand at a modest to moderate pace across the 12 Federal Reserve Districts in March and early April.*

to this in May:

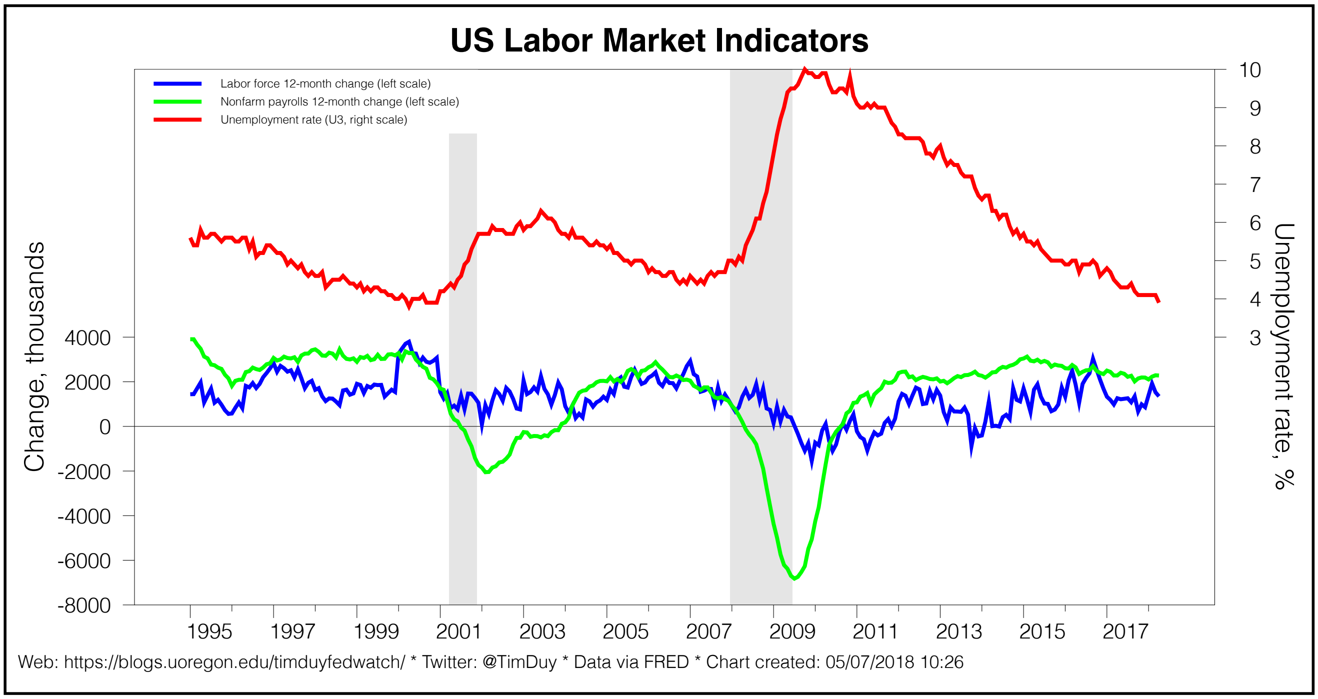
> *Economic activity expanded moderately in late April and early May with few shifts in the pattern of growth.*

This fits with the story of the Atlanta Fed and New York Fed trackers, which are coming in at 4.0% and 3.0% respectively for the second quarter, which in either case would be an acceleration from the 2.2% growth of the first quarter.

Such a pace of growth would sustain concerns that the economy will overheat in the absence of further rate hikes. As long as those concerns are alive and well, the Fed error on the side of rate hikes until they approach a policy rate that is closer to neutral. They won't want to be too far from neutral should the economy overheat; they won't want to push past neutral and unnecessarily tip the economy into recession. I suspect they will only push past their estimate of neutral if inflation overshoots substantially (greater than 2.5%) and does not appear likely to return to target without a more aggressive policy stance.

What this means for policy is that assuming the current pace of growth can be sustained, the Fed will likely hike at the next two meetings to move to the bottom end of neutral estimates. To be sure if growth falters (or financial chaos spreads from Europe or emerging markets), they will reassess the timing of the next rate hike. But that is a risk at this point, not my baseline scenario.

Bottom Line: Expect incoming data to continue to support the case for gradual rates hikes, but watch for the Fed to shift gears to a slower pace of hikes after closing in a bit more on estimates of the neutral rate. That slowing in the pace of hikes assumes inflation remains contained.



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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*.

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