Tim Duy's Fed Watch

OCTOBER 9, 2017

On Track For a December Rate Hike

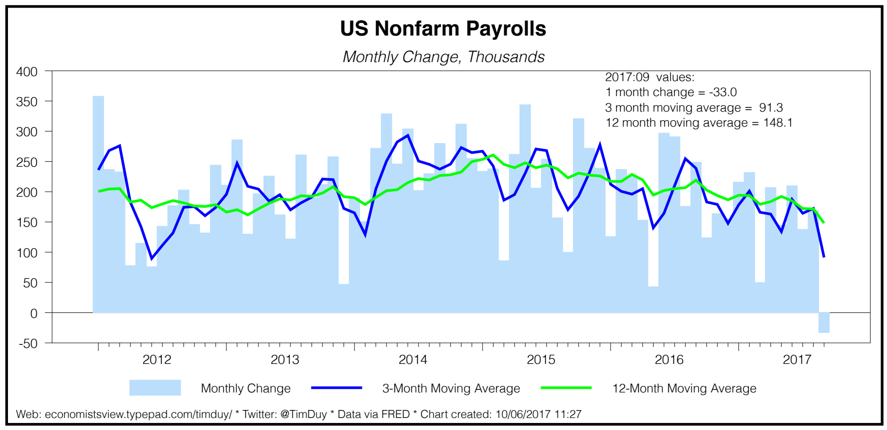
The headline figure on nonfarm payrolls report came in well below already withered expectations, but the disappointment was more than compensated for in the details of both the establishment and household survey. **The Fed is looking for data that allows them to overlook the weak inflation data. This was just that sort of data.**

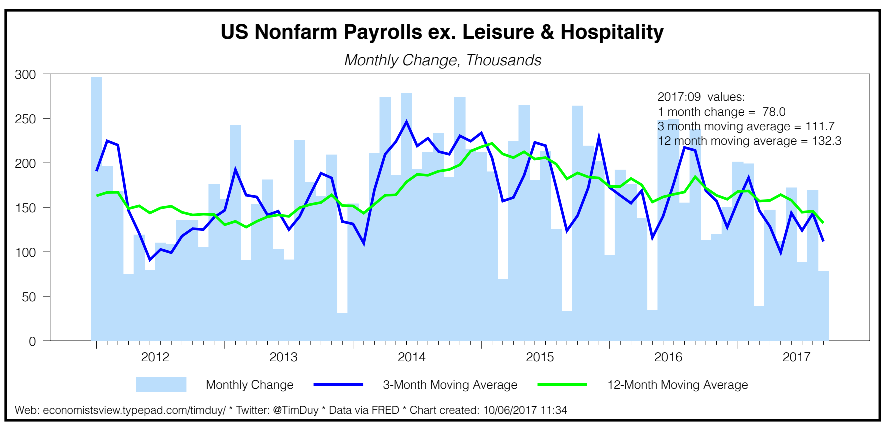
Nonfarm payrolls sank by 33k, and prior months were revised down. The three-month average is just 91k, which would put the job growth in-line with the range Fed officials believe is consistent with a steady unemployment rate.

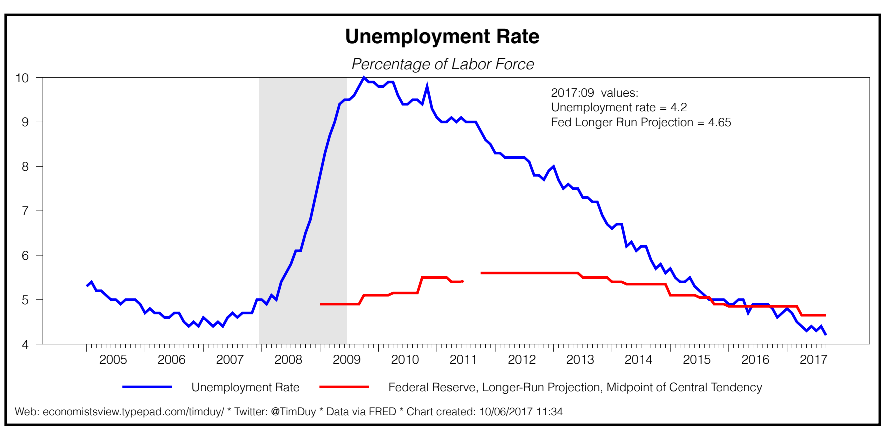
But there was little doubt that Hurricanes Harvey and Irma distorted the data, with a particularly large impact on leisure and hospitality numbers. That sector lost 111k employees during the month and looks to have borne the brunt of the impact.

Interestingly, non-farm payrolls excluding leisure and hospitality remain in the range of recent trends. Like overall nonfarm payrolls, the pace of growth entered a gradual slowing phase in 2015. This behavior looks consistent with what would be expected as the economy approach full employment and labor becomes more difficult to find.

Speaking of full employment, the unemployment rate fell to 4.2%. Recall that in the Fed's latest Summary of Economic Projections, policymakers projected the unemployment rate to fall to 4.3% by the end of the year. We are a little ahead of schedule, it seems. Note that according to the Bureau of Labor







Statistics, the hurricanes did not impact the estimate of the unemployment rate.

The decline of the unemployment rate should not be a surprise. Job growth continues to track above labor force growth, a situation that typically results in a falling unemployment rate. Moreover, the Fed's unemployment forecast always seemed suspect. The forecast GDP growth rate through 2019 exceeds potential GDP growth; this would on average suspect greater downward pressure on unemployment than implied by the Fed's forecast.

An unemployment rate at 4.2% will rattle Fed officials already worried about pushing too far below full employment under the current projections. **This will go a long way toward offsetting their nagging worries about low inflation.**

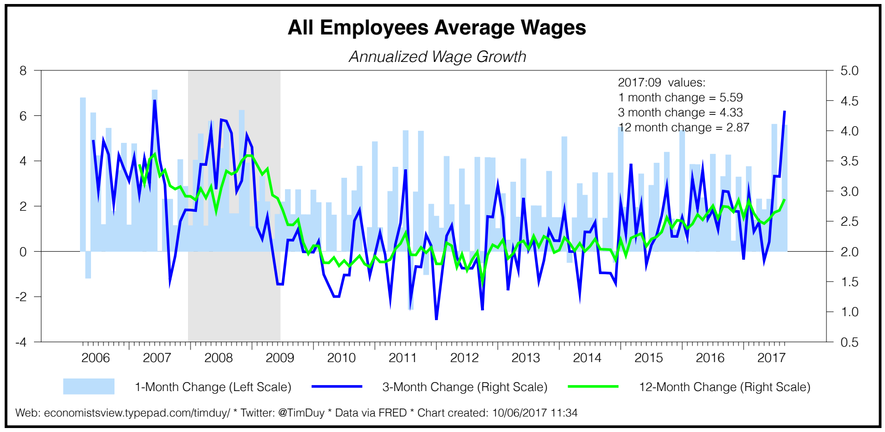
The pace of wage gains accelerated sharply in September. Composition effects due to the loss of lower paid leisure and hospitality jobs might account for part of the gains. But take note of two points. First, hourly wages have generally seen upward revisions in recent months (the September vintage overlaps the August vintage, so I excluded the latter). Second, wage gains in the third quarter look more consistent and broad-based than the rest of the year.

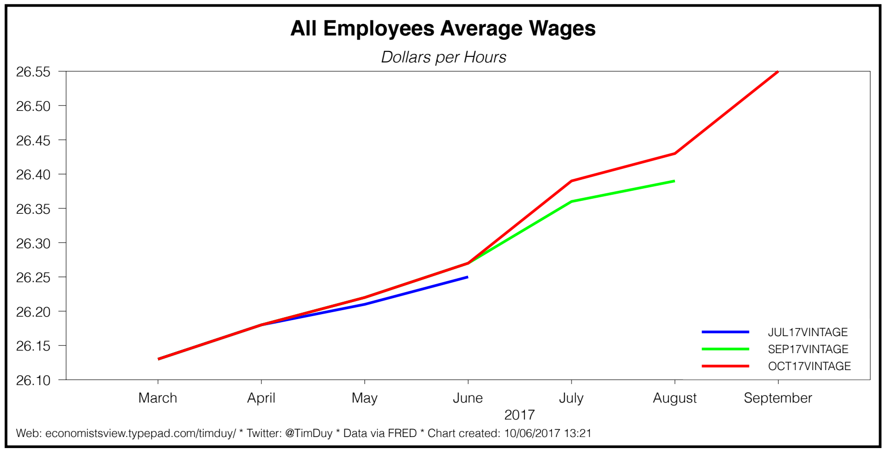
Hence, we should not discount the possibility that in these wage numbers we see the lagged impact of unemployment running below its longer run rate. Certainly, we need more data to be certain. It would be unwise to read too much into what we know is a hurricane-muddled report. But Fed officials will tend toward this interpretation.

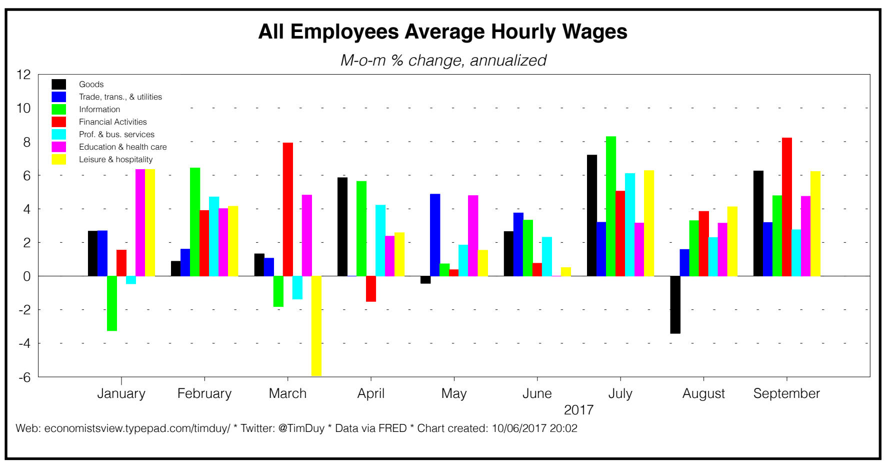
Finally, note that temporary help payrolls continue to climb, suggesting that while employment growth might be softening as the expansion matures, but the economy remains in the expansion and is not poised to turn toward recession.

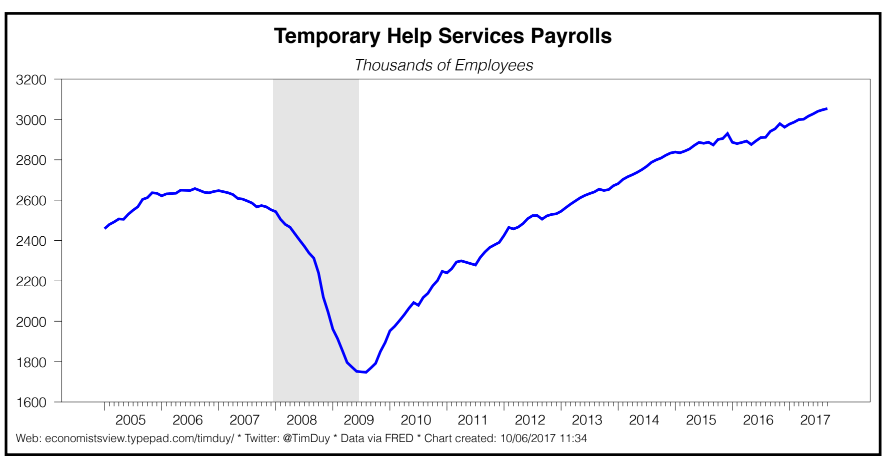
Atlanta Federal Reserve President Raphael Bostic offered an assessment of the labor report that I think will be largely shared by his colleagues. Via Bloomberg:

> *"We knew the hurricanes were really going to give a hit to some of these top*









line numbers," Bostic said after a speech in Austin, Texas. "The numbers underneath are actually quite interesting. They suggest some of the strength we were starting to see at the beginning of August, the storms didn't completely wash them out."

Bostic looks ready to support a December rate hike, assuming the economy continues to post solid numbers. He also downplayed inflation concerns:

"We have seen a slight decline, I think, but nothing that would suggest there has been something fundamental that has changed in how consumers are viewing the marketplace," he said.

Inflation continues to rattle Dallas Federal Reserve President Robert Kaplan. Via Reuters:

"I would like to see more evidence of progress in reaching our inflation objective," he said, reiterating his concern that globalization and technology are keeping inflation muted, despite unemployment that sank in September to 4.2 percent.

Kaplan votes this year. Although he is among the group concerned about low inflation, he will likely not dissent against a December rate hike if the remainder of the data, on average, sustains a rosy outlook.

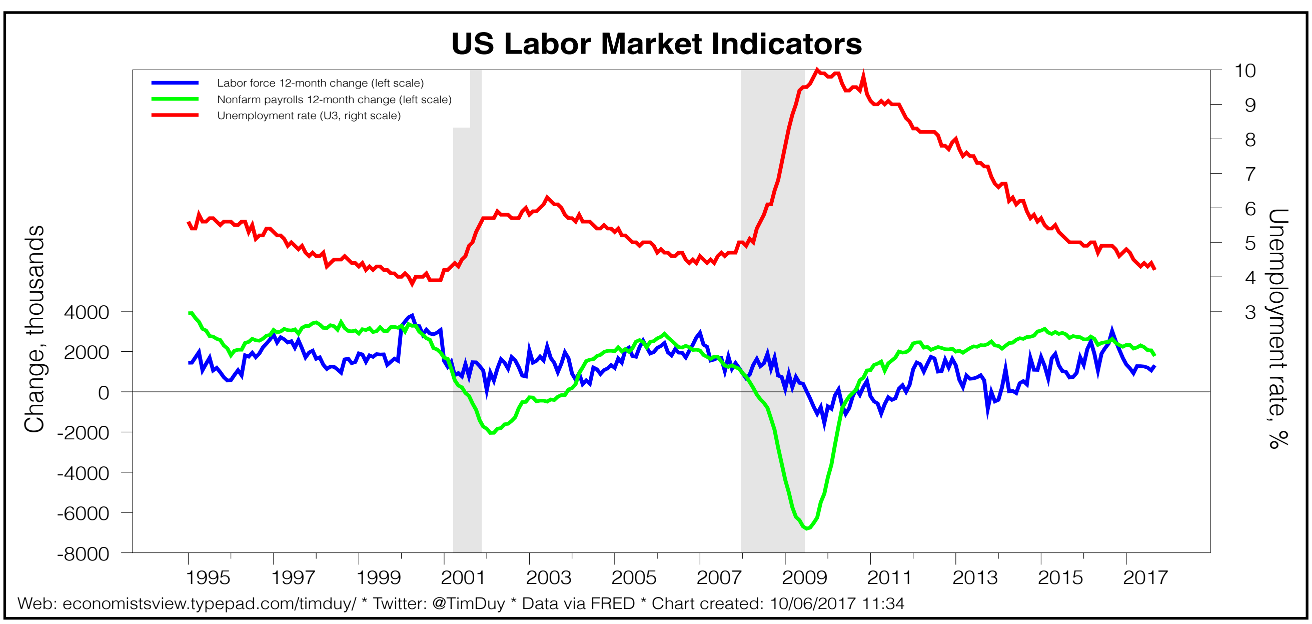
St. Louis Federal Reserve President James Bullard stuck to his desire to hold rates steady, worried that the Fed risks pushing inflation expectations lower with additional rate hikes. He wants more proof that inflation is heading higher before the Fed acts. Via Reuters:

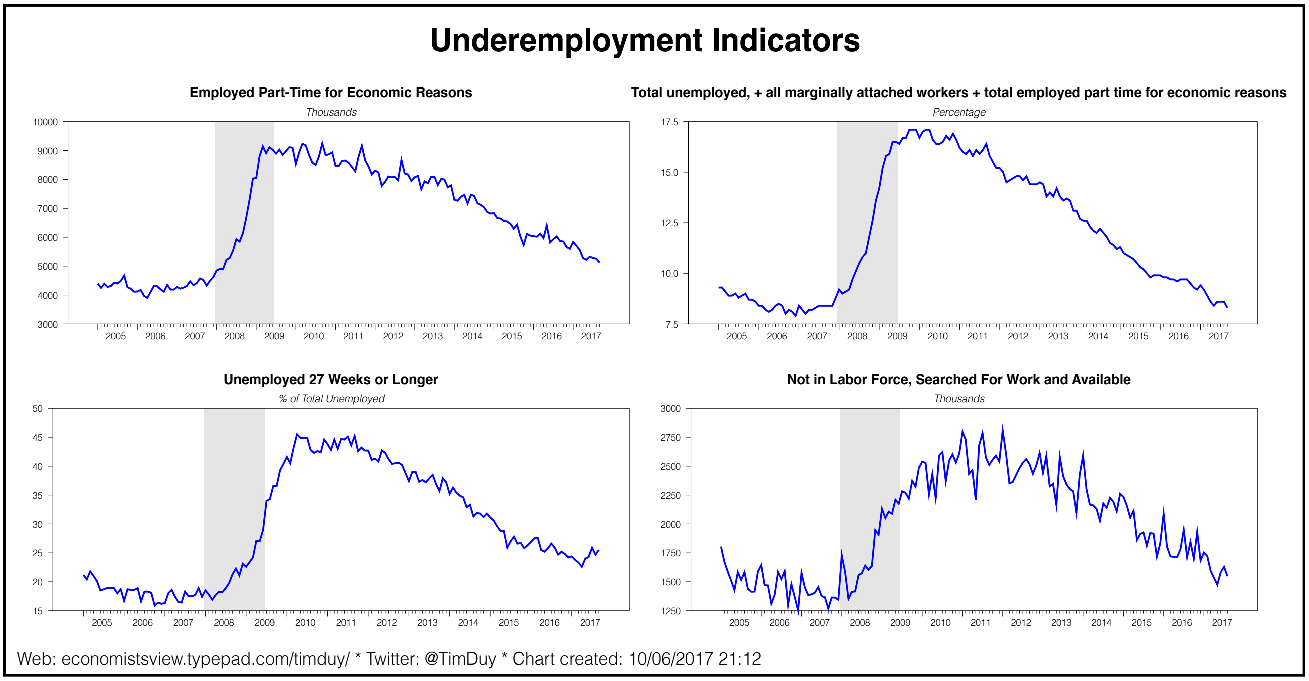
"The December meeting is going to be too early to make a determination on whether inflation is coming back. I don't see how we can get the data on that. I am getting more concerned that we might make a policy mistake."

The data calendar is a bit slower this week. Look for the JOLTS report (Wednesday), inflation indicator reports PPI (Thursday) and CPI (Friday), and readings on the demand side of the economy from retail sales and business inventories (both on Friday).

In addition, we have plenty of Fed speakers, including regional Presidents Kashkari (Tuesday), Evans (Wednesday), Bostic (Thursday), and Rosengren and Kaplan (Friday). I don't think we will see anything new from these speakers regarding monetary policy. Federal Reserve Governor Jerome Powell speaks Thursday (keynote address on emerging markets) and Friday ("Are Rules Made to be Broken? Discretion and Monetary Policy," an event for which I foolishly forgot to make an effort to attend). Neither speech will likely give direct policy guidance, but with Powell rumored to be a contender for the top spot at the Fed, they will offer additional opportunity to explore his thinking.

Bottom Line: December rate hike still a go; low unemployment outweighs low inflation for now. That will change next year if job growth slows further and unemployment stabilizes.





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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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