Incoming Data Supportive of December Rate Hike

If we ignore inflation, then nothing is really standing in the way of a rate hike in December. Of course, given that arguably the primary job of a central bank is to meet its definition of price stability, the Fed shouldn’t really ignore inflation. Policymakers, however, would counter that they are not ignoring inflation. They are simply favoring the inflation forecast over actual inflation. And they would further argue they have good cause – with the economy chugging along, it is only a matter of time before resource constraints become evident and price pressures rise. That’s their story, and they are sticking to it.

Industrial production rebounded in September after an upwardly revised August drop. Hurricane activity took a bite out of the August number and continued to impact the data in September. The Fed estimates that the hurricanes dragged down production growth by 0.25 percentage points in the most recent report. The short story is that despite the recent storm impacts, the underlying momentum in the sector remains positive, boosted by the waning effects of the 2015 oil price and dollar shock and stronger global growth.

Housing starts fell to a rate of 1.127 million units per year, compared to expectations of 1.17 million units. Here too the hurricanes had an impact, weighing on housing starts in the south. But the general upward trend of single family starts remains intact. Multifamily, however is a different story. It appears that peak multifamily is now behind us for this cycle, and the activity is being handed off to single family. Almost as might be expected as 1.) the Millennial bulge moved into their twenties and first non-parent housing and then 2.) as that same group ages and starts to turn their attention away from multifamily housing.

The Fed released the Beige Book Wednesday, a precursor to the upcoming FOMC meeting. Similar to previous reports, growth remains modest to moderate across Fed regions, with expected hurricane disruptions. Labor markets reportedly remain tight, so tight that conditions hamper the expansion of business activity. But wage growth remains elusive. Firms continue to focus on other recruitment and retention devices:
Growing use of sign-on bonuses, overtime, and other non-wage efforts to attract and retain workers were also reported.

Fed officials will fear that these non-wage efforts on the part of firms will only go so far before labor market tightness yields faster wage growth.

And then there are the even more elusive inflationary pressures:

Price pressures remained modest since the previous report. Several Districts noted increased manufacturing input costs, but in most cases these weren’t passed through to selling prices. Retail prices generally increased slightly. Transportation, energy, and construction materials prices increased more rapidly, with some Districts citing effects from hurricanes.

The lack of actual inflation has yet to change San Francisco Federal Reserve Resident John Williams’ mind on inflation. In an interview with Binyamin Appelbaum of the New York Times, Williams reiterates his faith in the Phillips Curve:

If you look until 2015 or so, the inflation data basically followed our models, emphasizing the role of weakness in the economy. Where this mystery has happened is really in the last year or two. I view both inflation picking up faster than expected in early 2017 and now the pullback as just part of the variability that’s going to happen. I don’t see any signs that somehow the inflation process is fundamentally changed.

I’ve been doing this a long time, and the Phillips curve has been declared dead far more times than Mark Twain.

I would be remiss if I didn’t mention the stock market, which continues to push higher into record territory. On net, the Fed will interpret this as a loosening of financial conditions, the opposite of what the Fed is trying to achieve with rate hikes. That argues for further hikes.

Note that the path of equity prices remains only a notch higher compared with the average of past rate hike cycles. This doesn’t surprise me. I think the simplest answer to steady stock price gains is probably the best – equity prices are likely to continue to rise until a very real threat to earnings, like a recession, is on the horizon. As long as the economy chugs higher, equity prices are more likely to rise than fall.

Meanwhile, President Trump claims he will announce a finalist for Fed Chair by November 3. He interviews Yellen Thursday. I still think the interview is largely perfunctory; Trump looks to be driven mostly by a desire to undo the Obama years, and that would including ditching Yellen.

Trump reportedly became enamored with Stanford economist John Taylor after an interview last year. A read through some of Taylor’s work during the crisis years raises the same kind of red flags as surround fellow Fed chair candidate Kevin Warsh. Taylor’s commitment to his namesake rule led him to push for tighter policy way back on 2009, for example. See also my take on his 2012 Wall Street Journal opinion piece with Phil Gramm.

And, for what it’s worth, note that after Taylor left the Treasury in 2005, then-President Bush nominated five people to the Federal Reserve board. Taylor didn’t get one of those spots. But Warsh got one of those spots. So Warsh > Taylor in the Bush administration?

Bottom Line: Solid economy = December rate hike. As far as the Fed chair is concerned, my preferences remain Yellen > Powell > Taylor, Warsh, Cohn.
S&P 500 Stock Index
Indexed to equal 100 on day of first Fed rate hike in cycle

Weekdays Before and After First Fed Rate Hike in Cycle


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 as “influential.” The Huffington Post identified him as 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.

© 2017 University of Oregon; Tim Duy. All rights reserved.