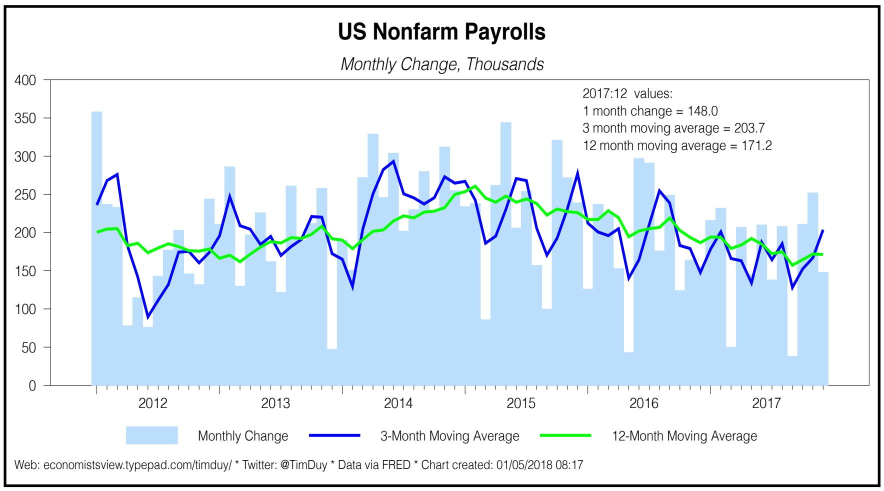
Tim Duy's
Fed Watch
JANUARY 8, 2018

Data Lining Up For The Fed's Rate Hike Forecast

Last Friday the Bureau of Labor Statistics released a fairly lackluster employment report. **In most ways, the story remains the same – steady improvement in the labor market but no signs of overheating in the form of wage growth. The mix will keep the Fed on track for three rate hikes this year,** as the consensus policymaker will view this kind of report as a reason to neither accelerate nor slow the pace of tightening.



Nonfarm payrolls grew a less-then-expected 148k in December. Still, after some mildly net negative revisions to previous months, jobs grew an average of 205k per month over the final quarter of the year and 171k per month over the last twelve months. **Unemployment held steady per expectations, but the pace of job growth remains well in excess of that necessary to pull the unemployment rate down in the months ahead. This is key for the Fed;** they would be more comfortable pausing rate hikes if job growth were something closer to 100k per month, a rate consistent with steady unemployment.

Claims of full employment by Fed officials notwithstanding, ongoing weak wage growth (up 2.5 percent compared to a year ago) suggests the economy does not face imminent danger of overheating. **While wage growth looked to be accelerating in the third quarter, that hope was yet again dashed later in the year. This smells of lingering slack in the labor market.** For example, see the continued gains in prime aged labor force participation rates with the possibility of more gains to come as the millennial generation becomes more integrated into the job market.

The combination of solid labor market improvement but tepid wage growth and low inflation leaves the Fed in an all too familiar position. Over the past year, they responded to that position with three rate hikes, plus initiated the process of reducing the balance sheet. The minutes of the final FOMC meeting of 2017 suggests the same response regarding rate hikes this year. The status quo dominates consensus thinking among central bankers:

> *Most participants reiterated their support for continuing a gradual approach to raising the target range, noting that this approach helped to balance risks to the outlook for economic activity and inflation.*

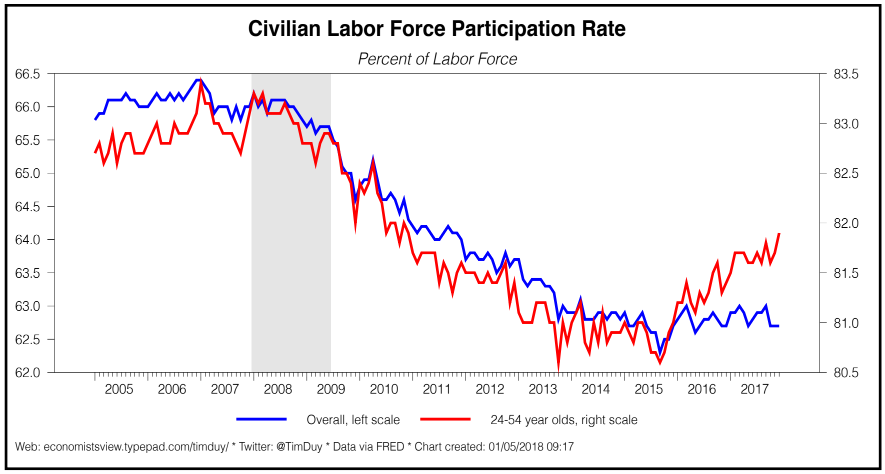
Those concerned about an overly aggressive projected path of rates remained in the minority:

> *A few participants indicated that they were not comfortable with the degree of additional policy tightening through the end of 2018 implied by the median projections for the federal funds rate in the December SEP.*

Another minority leaned in the other direction:

> *A few other participants mentioned that they saw as appropriate a pace of additional policy tightening through the end of 2018 that was somewhat faster*

than that implied by the December SEP median forecast. They noted that financial conditions had not materially tightened since the removal of monetary policy accommodation began, that continued low interest rates risked financial instability in the future, or that the labor market was increasingly tight.



It appears to me that neither the dovish nor hawkish contingents within the Fed are of sufficient size to drive the conversation. That leaves the status quo of three 25 basis point rate hikes as still the best bet for 2018.

The question is whether or not the status quo increasingly leans dovish in the face of continued inflation weakness. I hesitate to separate that issue from labor market strength. It seems to me that incoming data suggests healthy job growth is more likely than not going to continue in the year ahead. Initial unemployment claims remain low, temporary help employment continues to rise, and the overall economy looks to have gained some substantial momentum in 2017. All suggest continued solid employment gains and thus downward pressure on the unemployment rate. My sense is that the majority of the FOMC would continue to view such a situation as consistent with the gradual pace of hikes.

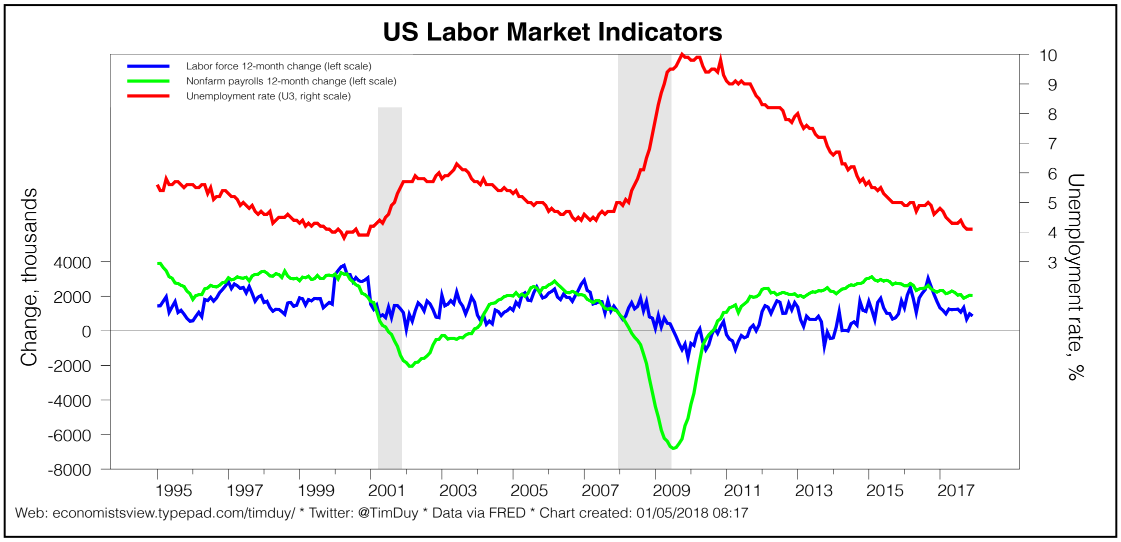
What would cause the consensus to lean in the dovish direction? Two likely possibilities jump out at me. First is an evident slowing in economic activity that looks sufficient to cut job growth almost in half. Second is falling inflation rates; I bet that in the context of a strong economy near what they think is full employment they will hesitate to stop hiking rates even if inflation meanders at current rates. But a decline of inflation at this point would be untenable and would shift the discussion solidly toward the group most worried by the possibility of declining inflation expectations.

And what about a more hawkish direction? On that side, I think you need a substantial rebound of inflation. But be careful here. Just as below target inflation has not deterred them from slowing the pace of rate hikes, nor should a symmetric miss on the other side of the target by itself trigger an acceleration in the pace of hikes. As long as the medium-term inflation forecast can reasonable predict a return to target under the current policy path, they can retain that policy path. Hence, to step of the pace of rate hikes, I think they need not only higher inflation but also clear evidence that the labor market will not slow to a more sustainable pace without a more aggressive rate hike path.

Regarding the composition of the FOMC in 2018, note that on Friday Philadelphia Federal Reserve President Patrick Harker said he thought two rate hikes were appropriate this year. I think then he is the sixth of the below median projection dots in the December 2017 forecasts. He stands along with Bullard, Evans, Kashkari, Kaplan, and Brainard. If these dot guesses are correct, then five of the six low dots are all nonvoters in 2018. **Hence the composition of the FOMC members leans hawkish.** This suggests to me that the data needs to break to the downside to shift consensus thinking toward dovishness.

Also note that a possible yield curve inversion is something of a wild card for policy this year. Whether or not the Fed could continue to hike rates even after the yield curve inverts remains an open question.

Bottom Line: The Fed looks on track for three rate hikes in 2018. If you are looking at weak inflation numbers as reason for the Fed to back down, be wary that the Fed will continue weigh the economic and jobs outlook heavily in their policy decisions. On the other side of the coin, central bankers will not overreact to a surprise rebound of inflation if they can remain reasonably confident their projected tightening is sufficient to return inflation to target in the medium-run.


US Labor Market Indicators
Labor force 12-month change (left scale)
Nonfarm payrolls 12-month change (left scale)
Unemployment rate (U3, right scale)
Change, thousands
Unemployment rate, %
4000
2000
0
-2000
-4000
-6000
-8000
10
9
8
7
6
5
4
3
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
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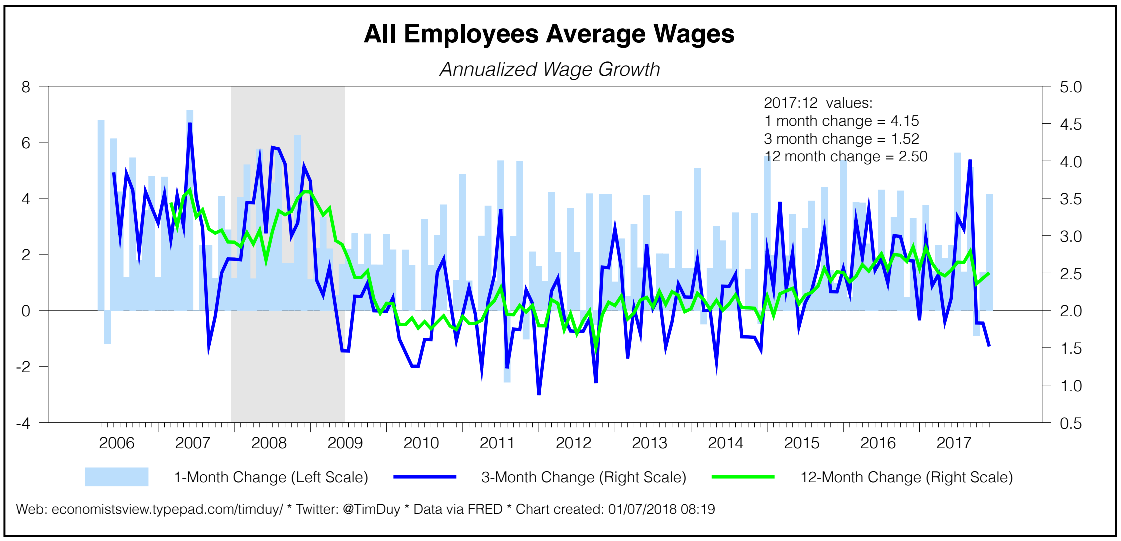
All Employees Average Wages
Annualized Wage Growth
2017:12 values:
1 month change = 4.15
3 month change = 1.52
12 month change = 2.50
8
6
4
2
0
-2
-4
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
1-Month Change (Left Scale)
3-Month Change (Right Scale)
12-Month Change (Right Scale)
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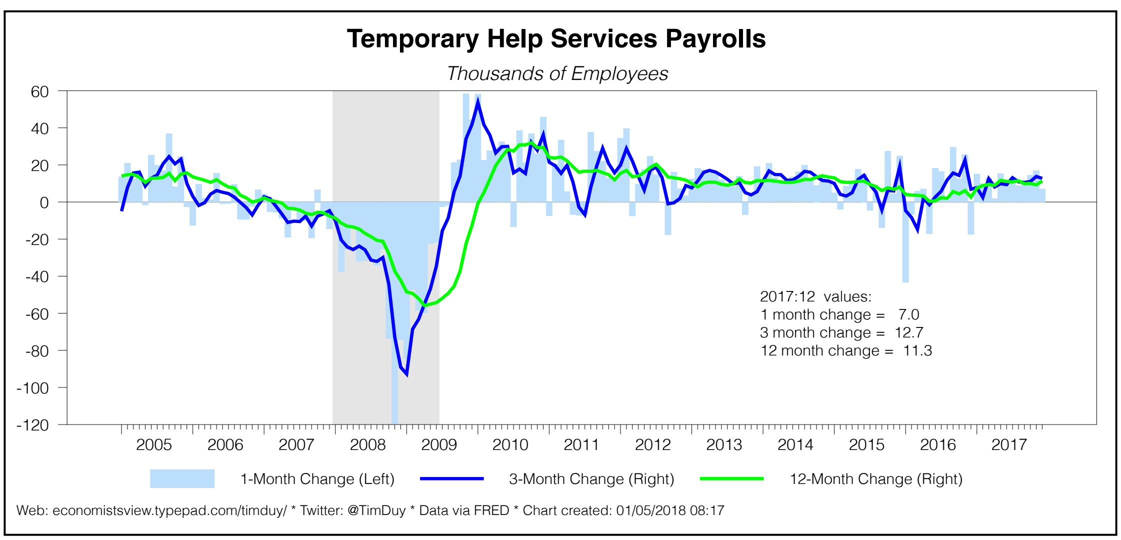
Temporary Help Services Payrolls
Thousands of Employees
60
40
20
0
-20
-40
-60
-80
-100
-120
2017:12 values:
1 month change = 7.0
3 month change = 12.7
12 month change = 11.3
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
1-Month Change (Left)
3-Month Change (Right)
12-Month Change (Right)
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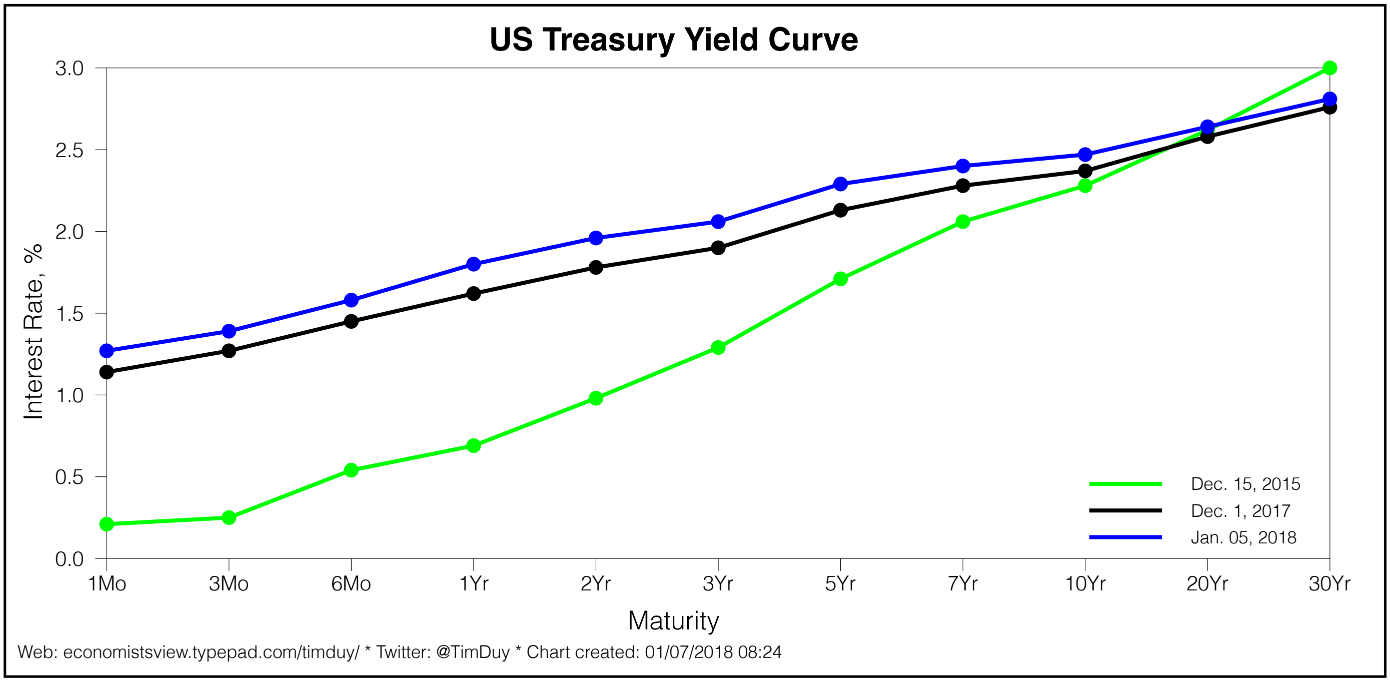

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Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department 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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