Weekly Market Review

August 25, 2014 — August 29, 2014

"Stochastic shocks are the antithesis of transitory, or what some refer to as cyclical, shocks that, by definition dissipate over time…. In 2009 I put forward the idea that the crisis and recession were caused by a shock that likely had either permanent or very long lasting consequences for the economy… If we view the shock we experienced as largely permanent in nature, in contrast to being largely transitory, then it alters the way we should think about gaps and about the policy responses. " - Charles Plosser

Wage Rigidity and the Impact on Monetary Policy

The Federal Reserve has committed to a dual mandate: seeking full employment and price stability. Price stability has been communicated as a target inflation rate of 2% based on PCE. There is little in the way of analysis here as the FOMC has communicated an absolute value level as their target. The committee's target for full employment is less clear. To the extent that monetary policy is a useful tool in achieving employment goals, there must be some degree of slack or cyclicality in the labor market. Structural unemployment cannot be well treated with traditional monetary policy tools and is better suited for fiscal policy reform. The 6.2% unemployment rate is a factor of labor market improvements and a reduction in the overall work force. Thus, the quantification of slack is important in understanding the future of monetary policy—alternatively said—we are interested in what proportions of labor market dynamics reflect cyclical shifts and structural weaknesses.

Differing interpretations of data leave this question very open-ended. To be sure we capture such a diversity of opinion—Richard Fisher of Dallas Fed, Jeffrey Lacker of the Richmond Fed, and Charles Plosser of Philly Fed support a largely structural argument of the unemployment rate. They would focus on the declining labor force participation rate due to baby boomers finding retirement, educational gaps and misalignment of worker skills with employer needs, as well as permanently discouraged workers. Denis Lockhart of Atlanta—and to some extent—William Dudley of the NY Fed and Yellen, Fed Chair, take a more cyclical approach looking to disability applications, elevated part-time workers, and educational enrollments which both reflect poor job prospects.

In Janet Yellen's Jackson Hole speech, the discussion of wage rigidity came up. A recent paper out of the San Francisco Federal postulates that the slow wage growth could be a result of pent up wage deflation. Employers were either unwilling or unable to lower wages during the financial crisis. Now that the crisis has concluded, wages are being held down to compensate for what declines should have occurred. The conclusion is that wage may rise slower as the labor market strengthens. This theory of downward nominal wage rigidity is picking up some steam in the policy circles, however, policy makers can derive different conclusions. If you buy the concept, you may then conclude that wage growth depression might not be as bad as was previously thought. In fact, wages may rise without having adverse inflationary pressures which is consistent with the dual mandate. Wage rigidity helps us quantify cyclicality, and the result is that its abating—See the SF Fed paper. As wages rise, quits will rise as is the pro-cyclical nature of the job hunt (you are more likely to leave work if you are confident you can find work easily—the quits rate has picked up over the last year). Alternatively, one may view this as the need to maintain a high degree of stimulus until said deflationary pressures emerge. Regardless, pent-up wage deflation theory gives us the vocabulary to discuss wage related impacts on unemployment. I believe that the discussion around wage rigidity and quits will become more popular when considering tightening policy and will serve as additional evidence of a stronger labor market. To be fair, the chief economist at Goldman Sachs refutes Yellen stating that evidence he has seen is the opposite.

We will look to the Employment Situation Report and the ADP Employment Report next week for additional details on the state of the labor market. Expectations are around .2% increase in average hours worked MoM and an increase in payrolls. No doubt that a positive report will cause bond markets to fall (yields to rise) which may help reverse some of the recent pain we have felt in the roughly 22bp MoM drop in the long end of the USD/Libor swap curve as well as the general decline in mortgage rates.