C.F. Whittelsey Holdings

Weekly Market Review

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How Full is the Glass? Reviewing the Labor Market Discussions this Week

Unemployment is down to a pre-recession low at 5.8% The ADP estimate of private payroll growth was 230k, private payrolls came in at 209k and nonfarm payrolls rolled in at 214K MoM. All of these were in line with expectation although a little on the low side. Hourly hours worked are flat, wages moved up a minor .1% and there was a sharp rise in layoffs in the Challenger Job-Cut Report. So how is the labor market doing?

There is a wide variety of opinion on what exactly the appropriate rate of unemployment should be. Only a year ago we had a 6.5% target rate of unemployment which falsely (due to poor Fed communication) was determined as the key metric to pass before rate hikes began. Kocherlakota and Charles Evans look for somewhere between 5.25 and 5.5%. James Glassman out of JPM believes its closer to 4%. So what is the disparity? (excluding demographic factors—no doubt job skill mismatch is a huge problem, but lets keep the discussion out of the realm of fiscal policy)

Glassman would argue those that think a 5.5% unemployment rate "went to sleep in 1995 and forgot that something changed over the last two decades". He argues there is still considerable labor market slack as the official unemployment rate doesn't capture those that are involuntarily part time and drop-outs of the labor market who are likely to come back (in the mean time they are in school, or living off of government programs. This of course is a true statement and the state of the problem with the U3. U6 unemployment rate is about 11.5%) . Those of the Glassman kind would argue that the shadow labor force (or marginally attached or uncaptured unemployed, or what-have-you) amounts to about 3-4 million more than normal/optimal levels. It is of course obvious that sustained labor market improvements haven't translated into wage growth and normal hourly earnings may be at risk of not outpacing inflation.

Reinhart and Roggoff would suggest that we are in a post credit crisis recovery which are largely defined by subpar job growth. In fact, job markets are actually doing better than they have in the average post credit crisis periods. Jim O'Sullivan of High Frequency Economics observes that "the pace of employment is more than enough to keep unemployment coming down," and notes job gains showed their best improvement in 15 years. Those on the more hawkish side likely argue that the job gains are broad based, wage rigidity encompasses a great deal of stagnant wages against the backdrop of a continuously improving economy, real estate problems are behind us, and most of the risk lay in subpar growth internationally.

Enter Evans who states that the new unemployment rate gets us "much closer to a more natural sustainable rate of unemployment associated with full employment". As Evans is one of the more bearish Fed Presidents, one could read into this as a sign the Fed in aggregate is becoming more convinced that labor market slack is dissipating.

As managers of interest rate risk, we are interested in the Federal Reserve's impressions of the labor market as it drives (I would argue more than any other metric including inflation) the decision around when and by how much to raise interest rates. You could argue that—if we pull off the stimulus too early, then we will end up like Sweden who is now suffering with deflation, Europe which couldn't be more stagnant, or Japan who has thrown everything including the kitchen sink at their problem but with little positive outcome. David Blanchflower out of Dartmouth College would suggest that rates should be raised later rather than sooner because the potential adverse effects of waiting longer are less than the potential adverse effects of acting now. Dudley may well agree as he cited the biggest mistake of the 1930s was a premature tightening of monetary policy which came to be known as 'The Mistake of 1937'. Alternatively, you could align yourself closer to Richard Fisher who observes the US economy has largely overcome its woes that monetary policy can fix and its time to pull Fed stimulus as each additional dollar invested has a declining marginal benefit and increases stability risks in the financial markets. All in all, little new has changed in terms of trend and we should not expect monetary policy to be widely impacted. I believe, *ceteris paribus*, that we will see the first rate hikes in July or Sept of 2015.