Weekly Market Review

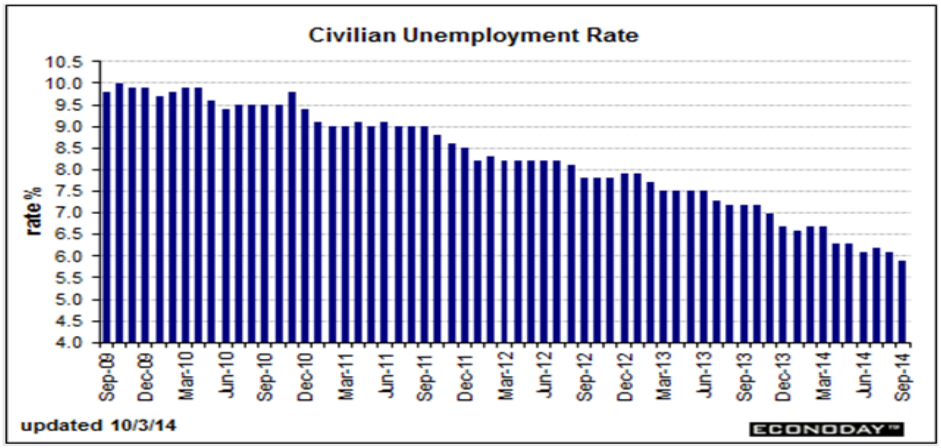
September 29, 2014 — October 3, 2014

"If there are no wage gains, consumers are unlikely to increase the quantity of goods they buy, on net, and demand pull inflation should remain pretty tame…. What it means is that it gives you some cushion if you move to late — it reduces the risk of waiting too long" Guy Lebas, Chief FI Strategist and Janney Montgomery

"A policy rate liftoff in the first quarter of 2015 would exhibit considerable patience relative to the plans laid out in September 2012… Unemployment has turned out to be much lower than the committee projected… [regarding wage growth] labor market indicators are very highly correlated. How much information are you really getting form all these extra indicators that you don't already get from unemployment and non-farm payrolls?" - James Bullard—St. Louis Federal Reserve President/CEO

A Few Facts:

- The US unemployment rate ha fallen to 5.9% from its Oct 09' high of 10%
- In Sept 2012 the Fed estimated 4Q2014 unemployment to be between 6.7-7.3%
- Hourly wages are up 2% over the last 12 months
- Employers added 248k workers last month, largely driven in the services sector
- PCE (the Fed's favorite inflation index) sits at 1.5%
- Unemployment factoring marginally attached workers and part timers is at 11.8% from precrisis levels of 8.8%



Do we care what's behind the 5.9%?

Thoughts of practitioners: Janet Yellen—the unemployment expert—continues to believe that there are too many people who want jobs but cannot find them leading to underemployment and elevated part time work. This underutilization of labor resources results in low/stagnant wages which is why the unemployment rate isn't the best indicator. Evens (Chicago fed president) and Bullard believe that the Fed is being too patient in driving up rates given the success in reducing the jobless rate. While the inflation discussion has been underweighted in monetary policy discussions for some time, practitioners like Michael Pond—Head of Global Rate Strategy at Barclays) suggests that PCE will remain flat and for that reason the Fed will be unlikely to raise rates in the near or medium term.

There are two primary components of unemployment behind the headline unemployment rate; wages and labor force participation. If you want to know what will move the Fed doves, its these two topics. The labor participation rate is to a new low. Re-entrants and new entrants into the labor force is down about 500k over the last year. One goal of the stimulus was to create a more robust economy (GDP 4.6%) decrease unemployment (5.9%) and increase confidence (fairly possitive) which should incite workers to go back to the labor force and find work. It perplexes the Fed why exactly they haven't seen this trend in participation. <u>I believe that 1/2 million leaving instead of coming back speaks to slack abating. It suggests that their re-entry isn't predicated on things like confidence, or waiting out short term cycles—things that the Fed can target through policy initiatives. Instead, their absence is based on their inability to return—that is to say they lack the skills and education that employers are currently looking for. There are very long term structural issues that impact the participation rate.</u>

Wage growth is limited by high precautionary savings rates, demographics, and credit growth which are working against inflation. Note that wages make up some 60% of inflation. The average duration of unemployment is still very high which may suggest increased competition and selective preferences of firms, however—we did see the average workweek climb up to its highest levels since the recession. Additionally, the PCE Index showed wages and salaries component was even stronger than expected up .4% MoM. Most of Janet Yellens dashboard is not as good as the headline rate would suggest. I think we can learn something from the new LMCI index the Fed has produced which will come out tomorrow. I do buy the wage rigidity argument—some employers didn't cut wages during the crisis. As swaps are to banks, wage maintenance was to employees during the crisis. They pull forward future earnings, but in the current years, they pay for that wage allowance they received with historically slow salary growth.

<u>No doubt the gradual nature of slack dissipation affords the Fed a longer time frame for policy accommodation.</u> I'm suspect a key driver of cyclicality (or the uncertainty around the difference between structural unemployment) is derived from employer uncertainty around future economic conditions. It is difficult for firms to make long term invest decisions when they lack clarity. The Fed, in no small way, signals to the public on the fragility/stability of the economy through the degree of accommodation they provide. I believe a move up in the FF rate, and toward normalized monetary policy, will create business confidence and spur more full time employment.