Weekly Economic Commentary

June 16, 2014

FOMC: Need to Know

John Canally, CFA
Economist
LPL Financial

Highlights

We continue to expect the Fed to trim QE by $10 billion per month this year and to remain on pace to exit QE by the end of 2014.

Our view remains that the current center of gravity at the FOMC will likely err on the side of keeping rates lower for longer.

Markets should expect that the Fed will be content with keeping its fed funds rate target near zero until key labor market indicators make significant progress toward "normal."

For more details about the Beige Book Barometer reading and Janet Yellen's labor market indicators, please see our *Weekly Economic Commentary: Beige Book: Window on Main Street* from June 9, 2014 and our *Weekly Economic Commentary: Janet Yellen's Employment Report* from March 3, 2014.

We are focusing on the health of the labor market and the impact of the three new members of the Federal Open Market Committee (FOMC) ahead of this week's meeting.

On June 17–18, the FOMC will hold the fourth of its eight scheduled meetings this year, and the second meeting this year that is accompanied by a new economic and interest rate forecast. It's also the second that will be followed by a press conference by Federal Reserve (Fed) Chair Janet Yellen. We continue to expect the Fed to trim its bond purchases—also known as quantitative easing (QE)—by $10 billion per month and to remain on pace to exit QE by the end of 2014. We also continue to expect that the Fed will maintain its promise to keep rates low for a "considerable time" after the QE program ends.

The conundrum for FOMC members—and especially Chair Yellen—will be how to explain the still accommodative monetary policy against the backdrop of:

- Accelerating wage and consumer price inflation;
- The bust/boom first half of 2014 for gross domestic product (GDP); and
- The recent solid performance of the labor market.

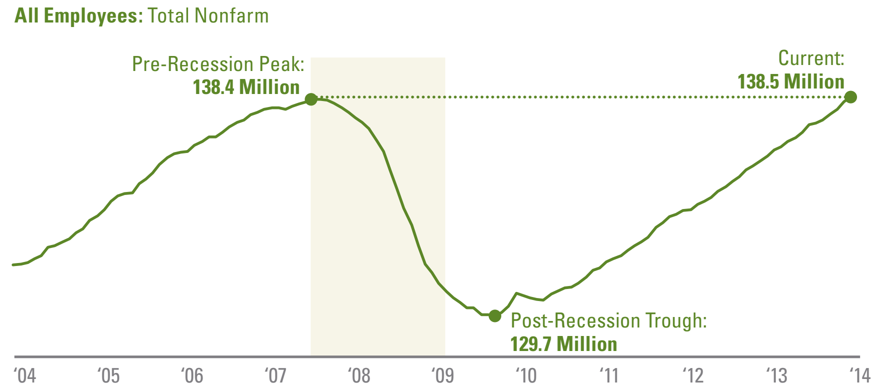
Lower for Longer

Our view remains that the current center of gravity at the FOMC—Yellen, New York Fed President Bill Dudley, and newly confirmed Vice Chair Stanley Fischer—will likely err on the side of keeping rates lower for longer. In addition to Fischer, the FOMC will welcome two other new voting members at this meeting: President of the Cleveland Fed Loretta Mester, and Lael Brainard. Mester is the former director of research at the Philadelphia Fed under Philadelphia Fed President Charles Plosser. Because Plosser is a policy "hawk," markets have already assumed that Mester is also a hawk. Brainard was the undersecretary of the Treasury for International Affairs during the first term of the Obama administration. Typically, Fed governors line up behind the chair of the Fed on monetary policy. The addition of the three new members of the FOMC will raise the market's awareness of the economic and interest rate forecasts set to be released by the FOMC this week.

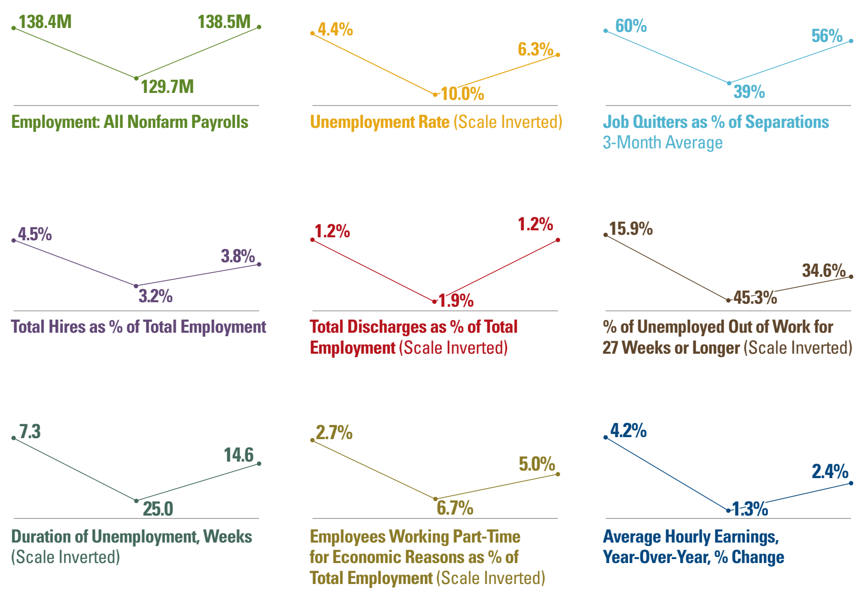
A Closer Look: Participation Rate

- For years, the labor force participation rate has been an afterthought in the monthly employment report and received little attention from the market, the media, the public, or political pundits. Although the market continues to largely ignore the number, it gets a lot of attention each month from the other groups noted above. The participation rate (62.8% in May 2014) is calculated by dividing the labor force (155.6 million in May 2014) by the civilian population over the age of 16 (247.6 million in May 2014). This metric ran up sharply between the early 1960s (58%) and early 1990s (67%), when women entered the labor force like never before. The participation rate among women age 20 and over was around 37% in the early 1960s, but by the early 1990s, it was close to 60%. The overall participation rate plateaued in the 1990s, peaked at just over 67% in the early 2000s, and has been falling ever since.
- According to the nonpartisan Congressional Budget Office (CBO), the sluggish economy, demographic trends, and the unusual nature of this recovery account for the three percentage point drop in the participation rate since 2007, with the aging of the population accounting for half of the drop. The oldest baby boomers began turning 65 in 2011. The participation rate of people 65 and above is less than 20%, so as a greater portion of the population turns 65, the participation rate will continue to decline. Indeed, the CBO projects the participation rate will continue to decline over the next 10 years (albeit at a slower pace than over the past few years) and hit 60.8% by 2024.

The Labor Market Is on the Mend, but Not “Back to Normal”



The peak/trough/current pattern exhibited by various measures of the health of the labor market are all telling the same story:



Source: BLS, Haver Analytics 06/16/14

Shaded area indicates recession.

Note: The time frame for all charts is the last 10 years: 2004–14.

Since the last FOMC meeting on April 30, most of the U.S. economic data has come in stronger than expected, including the employment data, but the latest reading for first quarter GDP was a 1% decline and may get revised lower. The Beige Book Barometer from the June 2014 Beige Book was +102, the second highest in the past 10 years and well above the +87 reading in the Beige Book released prior to the April FOMC meeting.

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Financial conditions, as measured by the Bloomberg Financial Conditions Index, have continued to improve since the last FOMC meeting, but the crisis in Ukraine in late April has given way to a renewed crisis in Iraq on the geopolitical front. Since the last FOMC meeting, the European Central Bank (ECB) initiated another round of policy actions aimed at unsticking the European financial transmission mechanism but stopped short of embarking on QE. The FOMC's (and the market's) focus, however, remains on the health of the labor market.

Labor Market Indicators

Earlier this year — first, in testimony before the Senate Banking Committee and later, in her post-FOMC press conferences, testimony before the Joint Economic Committee (JEC) of Congress, and in other public appearances — Chair Yellen has mentioned several labor market indices that she and other FOMC members are watching closely. This week's press conference and post-FOMC meeting narrative provide another opportunity for Yellen to narrow, add to, or refine the list.

Our read on the tone of remarks by Fed officials in recent weeks is that they are willing to tolerate higher inflation in exchange for more improvement in the labor market. The market will be looking for confirmation of that tone in the FOMC statement, the new FOMC economic and interest rate projections, and in Yellen's post-meeting remarks and Q&A session with the media. As we have noted in prior commentaries, the risk in this view for financial markets — and especially the bond market — is that there is less slack in the labor market than Yellen and most other members of the FOMC think there is. If market participants sense that wage pressures are gaining momentum, and that the Fed is "behind the curve" on inflation, bond yields could rise rapidly over a short period, counteracting the monetary stimulus the Fed is supplying to the economy.

The infographic on page 2 details the performance of nine key labor market metrics mentioned by Yellen in her recent public appearances. As we have noted several times in the past few months in this publication, although most metrics have partially recovered from their Great Recession nadirs, only a few have returned to "normal." Until they do — or at least until they make significant progress toward normal — markets should expect that the Fed will be content with keeping its fed funds rate target near zero. In our view, the Fed is not likely to begin raising rates until late 2015 or even early 2016. ■

A Closer Look: Labor Market Surveys

- A survey of 60,000 households nationwide — an incredibly large sample size for a national survey — generates the data set used to calculate the unemployment rate, the size of the labor force, part-time and full-time employment, the reasons for and duration of unemployment, and employment status by age, educational attainment, and race. The "household survey" has been conducted essentially the same way since 1940, and although it has been "modified" over the years, the basic framework of the data set has stayed the same. The last major modification to the data set (and to how the data is collected) came in 1994. To put a sample size of 60,000 households into perspective, nationwide polling firms typically poll around 1,000 people for their opinion on presidential races.
- The headline unemployment rate (6.3% in May 2014) is calculated by dividing the number of unemployed (9.8 million in May 2014) by the number of people in the labor force (155.6 million). The civilian population over the age of 16 stood at 247.6 million in May 2014. A person is identified as being part of the labor force if they are over 16, have a job (employed), or do not have a job (unemployed) but are actively looking for work. A person is not in the labor force if they are neither employed nor unemployed. This category includes retired persons, students, those taking care of children or other family members, and others who are neither working nor seeking work.
- In May 2014, the labor force was 155.6 million, which consisted of 145.8 million employed people and 9.8 million unemployed people. Another 92.0 million people over the age of 16 were classified as not in the labor force. The 155.6 million people in the labor force plus the 92.0 million people not in the labor force is equal to the over-16 civilian population, 247.6 million.
- The payroll job count data are culled from a survey of 440,000 business establishments across the country. The sample includes about 141,000 businesses and government agencies, which covers approximately 486,000 individual worksites drawn from a sampling frame of Unemployment Insurance (UI) tax accounts covering roughly 9 million establishments. The sample includes approximately one-third of all nonfarm payroll employees. From these data, a large number of employment, hours, and earnings series in considerable industry and geographic detail are prepared and published each month.