INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective May 2021

KEY POINTS

- Federal Reserve policy is often a source of confusion for many investors.
- The Federal Reserve has a dual mandate of maximum employment and price stability.
- Maximum employment is the desired state at which all the unemployment rate falls to the natural rate of unemployment.

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FEDERAL RESERVE POLICY UPDATE

PART 1: MAXIMUM EMPLOYMENT

The Federal Reserve (Fed) was established on December 23, 1913, as a response to frequent financial panics and bank runs.[1] In the 1970s, Congress further established explicit objectives for the Fed, known today as the dual mandate of maximum employment and price stability. The Fed's policies are important to understand for investors because it works to promote a strong U.S. economy, which in turn provides a good environment for investment returns.

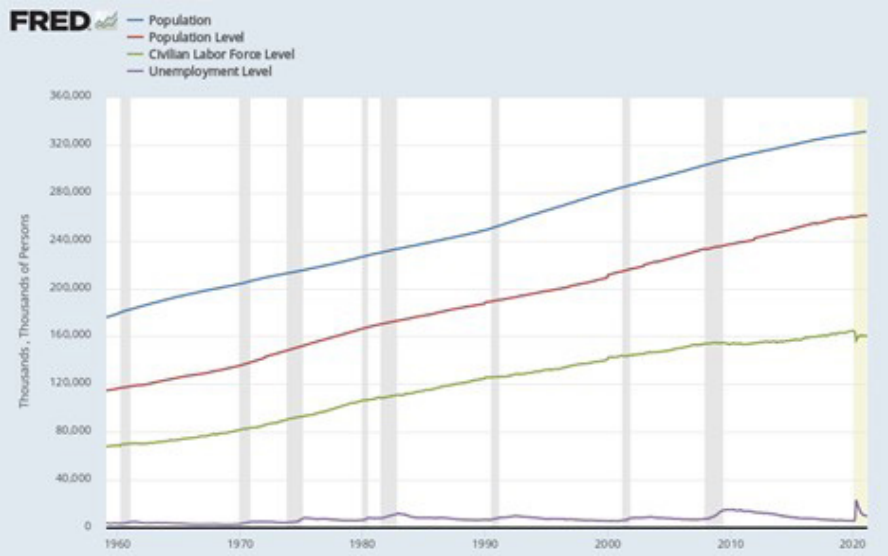
Yet, many individuals do not understand the Fed. According to a survey by Pew Research, less than 25% of individuals knew who the Fed chair was in 2014.[2] Another survey found that more than half of Americans do not recall the last time the Fed changed the interest rate.[3] A more recent survey found that more than 75% of Americans had a little or less knowledge about how the Fed operates.[4] This may be due to the complexity associated with understanding Fed's policies. Indeed, more than 70% of Americans find it difficult to understand Federal Reserve policies.[5] To help investors understand how the Fed operates, this issue of Investment Insights takes a close look at the first mandate for the Fed: maximum employment.

1 Federal Reserve Bank of San Francisco. "What Is the Fed: History."
2 Motel, Seth. "Who's in charge of the Fed? Don't Bank on Public's Knowledge of the Federal Reserve." Pew Research Center.
3 White, Martha C. "Nobody Really Knows What the Fed Does, but They Think It's Bad Anyway." NBCNews.com.
4 Axios. "Americans Who Don't Understand the Fed Don't Trust It."
5 Motel, Seth. "Who's in charge of the Fed? Don't Bank on Public's Knowledge of the Federal Reserve." Pew Research Center.

THE LABOR FORCE

Fed's mandate of maximum employment can be thought of as minimizing unemployment. Before we can talk about unemployment, it is crucial to understand the basics of the U.S. labor force. A common misconception is that the unemployment rate is the total number of people without a job divided by the number of people in the country. Instead, numerous definitions are used to define the labor force.

According to the U.S. Census Bureau, the total population of the United States was approximately 331 million in February 2021 (blue line in the chart to the right). However, this is not the number used in the calculation of the unemployment rate. First, people who are under 16, inmates at institutions, and active duty in the Armed Forces are subtracted from the total population to arrive at the civilian noninstitutional population. The civilian noninstitutional population, or the population level (red line), was approximately 261 million in February 2021.

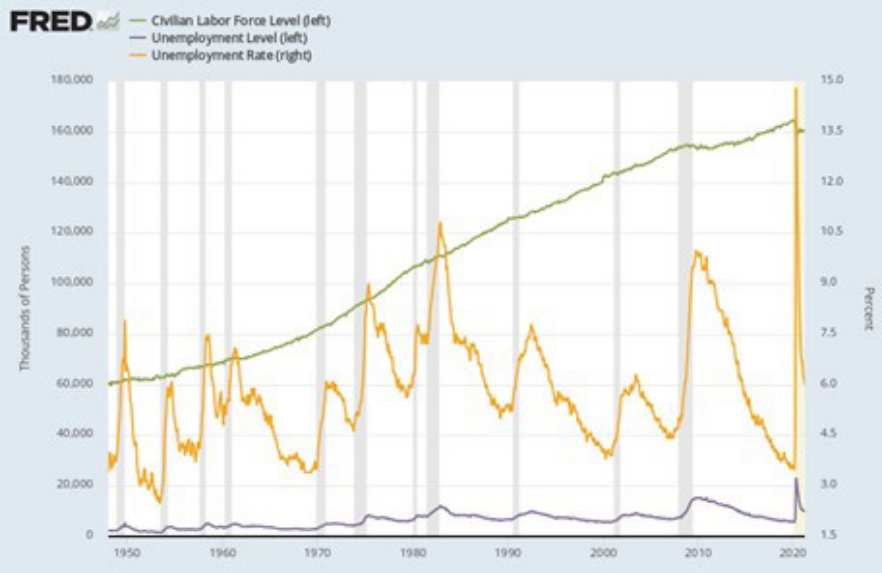


Source: U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics. Retrieved from FRED, Federal Reserve Bank of St. Louis.

Next, individuals who are not employed and have not actively looked for work in the past four weeks are subtracted to arrive at the number of people in the labor force. The civilian labor force (green line) was approximately 160 million in February 2021. The labor force is the total number of people available for work. It is made up of two components, the sum of employed and unemployed people. The number of unemployed individuals or the unemployment level (purple line above) was 9.97 million as of February 2021. With these definitions and corresponding numbers in mind, we are ready to talk about the unemployment rate.

THE UNEMPLOYMENT RATE

The unemployment rate (orange line below) measures the percentage of the labor force that is unemployed. The Bureau of Labor Statistics (BLS) calculates the official unemployment rate by surveying 60,000 households or approximately 110,000 individuals each month. The unemployment rate is calculated by dividing the number of people unemployed (purple line below) with the civilian labor force (green line below). In February 2021, for example, 9.97 million people were unemployed, and 160 million people were in the civilian labor force, making the unemployment rate approximately 6.2% (9.97 million divided by 163 million).



Source: U.S. Bureau of Labor Statistics. Retrieved from FRED, Federal Reserve Bank of St. Louis.

MAXIMUM EMPLOYMENT

Understanding the definitions above allows us to better grasp the Fed's goal of maximum employment, which is to achieve maximum sustainable employment and eliminate unemployment caused by recessions.[6] Zero unemployment is not possible, as some individuals are always between jobs. The measure for the desired unemployment level is known as the natural rate of unemployment (NROU) or full employment. The NROU changes over time based on trends in job-separation and job-finding rates. Currently, it is expected to be between 4.2 and 4.5 percent for the next decade.

The graph below shows the NROU (dotted green line) relative to the unemployment rate we calculated above. Notice that the unemployment rate is substantially more volatile than the natural rate of unemployment and tends to spike near recessions. The pandemic-induced recession last year increased the unemployment rate to the highest levels since the great depression. The Fed promptly reduced the short-term interest rate to zero to stimulate the economy.[7] The blue line shows the Fed's forecast on the unemployment rate, which you can see is not expected to reach the NROU until the end of 2021, suggesting the Fed is likely to keep interest rates low this year.

Source: U.S. Bureau of Labor Statistics, U.S. Federal Open Market Committee, Federal Reserve Bank of St. Louis, and U.S. Congressional Budget Office. Retrieved from FRED, Federal Reserve Bank of St. Louis.

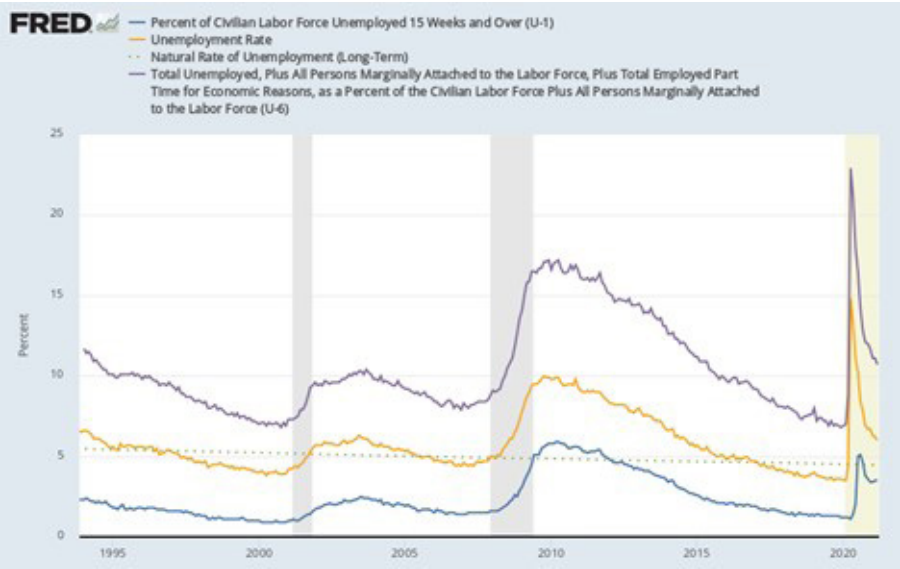
POLICY OUTLOOK

The projections provided by the Fed have also been reiterated by Federal Reserve chair Jerome Powell in media interviews and testimonies. Last fall, Powell said that while the economy continues to improve, it is "a long way from maximum employment." He repeated the same message again in his testimony to the House Financial Services Committee earlier in the year, adding that "there's a lot of slack in the labor market." Further, the Fed amended the definition of maximum employment. It is now "a broad-based and inclusive goal that is not directly measurable and changes over time." While emphasizing that maximum employment benefits all Americans is positive, the updated policy is more subjective as "broad-based" and "inclusive" are not clearly defined.

1 Note this is also known as cyclical unemployment.

2 Note that this controls the Federal Funds Rate, which is a rate at which banks borrow and lend from each other overnight.

One way to assess the updated employment goals is through the lens of various unemployment measurements. While the U-3 unemployment rate is the official gauge for unemployment, BLS reports five other measures of unemployment from U-1 to U-6 unemployment rates. The U-1 unemployment rate is the strictest measure of unemployment and is the percentage of the labor force that has been unemployed for 15 weeks or longer. The U-6 unemployment rate, on the other hand, uses the broadest definition of unemployment and counts discouraged workers (who stop looking for a job), marginally attached workers (not actively looking for a job), and unemployed workers (working part-time) in the unemployment rate. The graph to the right shows these measures of unemployment relative to the NROU.



Source: U.S. Bureau of Labor Statistics and U.S. Congressional Budget Office. Retrieved from FRED, Federal Reserve Bank of St. Louis.

As you can see, whether the Fed achieves its goal of full employment depends on how unemployment is defined. For now, the Fed believes it is a long way away from maximum employment and, as such, continues to be accommodating by maintaining a lower interest rate.

Some readers may be wondering why the Fed does not keep interest rates low indefinitely. After all, maximum employment is an excellent goal for the economy. This is where the Fed's other mandate – price stability – comes into play. We will explore this topic in the next Investment Insights.

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