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TRENDMACRO LIVE!

On the January Jobs Report

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David Gitlitz

The talking heads and financial press pondered whether the more significant number in today's **employment report** was the slightly below **expectations** increase of 193,000 in **nonfarm payrolls** or the surprising decline in the **unemployment rate** to 4.7%. In the **interest rate futures markets**, however, that debate was of little moment, and the message clearly taking hold is that in the face of mounting evidence of **economic vigor** -- of which today's jobs data are only the latest -- the notion that **the Fed** will soon put an end to its **rate hiking exercise** has been rendered all but moot.

That reality was already being digested even prior to today's release, with mid-year **fed funds futures** already pricing the highest rates yet seen in this cycle. At yesterday's close, July futures were showing a 50% chance of a 5% funds rate being in place by the end of June. As recently as early last week, the July contract was not even fully priced for a 4.75% rate target. Today with the **implied yield** bouncing another three basis points higher, the contract shows odds of 60% on a 5% overnight rate. A good part of this reckoning with reality has come since Tuesday's **FOMC meeting**, when the initial reaction was hope that the Fed might have been signaling at least a near-term **pause**. We viewed that interpretation as flawed, however, seeing modifications in the language of the **post-meeting statement** as mostly intended to avoid foreclosing any options for **incoming chairman Ben Bernanke**, whom we view as unlikely to take a substantively different tack in any case (see "On the FOMC Meeting" January 31, 2006).

In the **bond market**, meanwhile, after the **10-year Treasury** initially sold off by three-eighths of a point, pushing the **yield** above 4.6%, all of its early losses have been reversed, apparently taking a cue from the **short end** of the **curve**. There, the **2-year note**, while also posting the highest yields of this cycle at around 4.6%, continues to reflect a certain insouciance about the policy outlook. Essentially, the 2-year is saying that while the Fed might **hike rates** further in the next several months, it will inevitably be compelled to **cut rates** fairly soon thereafter in response to consequent economic weakness. That sentiment is also seen in the futures market, where the curve is now priced for the funds rate to fall by year end by 35 bps from its 5% peak.

We believe, however, that rates will need to remain **higher longer** than the market is now anticipating to completely quell the **inflationary impulses** embedded by the Fed's highly **accommodative posture** of the past three years. On that score, we were somewhat encouraged to see **spot gold's** response to today's numbers, with the price falling from nearly $575 to below $568. Although we view it as doing the right thing for the wrong reasons (see "Accidentally on Purpose" January 11, 2006), there's little doubt that with the unemployment rate falling from already historically low levels below 5%, and with inklings of strong **wage gains** beginning to appear (**hourly earnings** were up 0.4% last month) the Fed see itself in no position yet to put an end to this process. TM