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TRENDMACRO LIVE!

On the June Employment Report

Friday, July 7, 2006

David Gitlitz

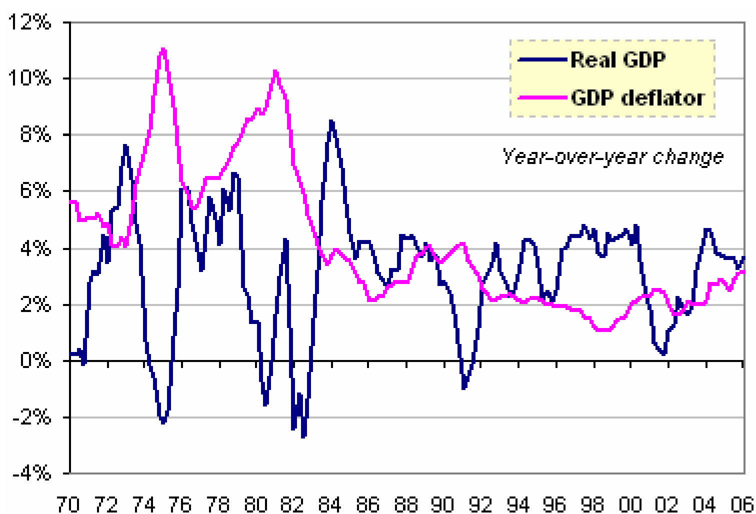
At first blush, the softer than expected gain of 121 thousand payroll jobs in the June employment report could be seen as building on last week's ambivalent FOMC statement in making the case for a pause in the Fed's restoration of a non-accommodative policy posture. But a closer look suggests the data are unlikely to soothe policymakers looking for confirmation that they can retreat comfortably to the sidelines after two years and 425 basis points of rate hikes. For one thing, the establishment survey's so-so gain in payrolls was once again contradicted by the much more robust results of the household survey, which showed growth of 387 thousand in total civilian employment. As we have often noted, the household survey's greater sensitivity to small business and entrepreneurial job creation appears to be better at capturing labor market dynamics in this expansion. In the past three months, household jobs have been averaging growth of better than 240 thousand per month; payroll jobs have been growing at a monthly rate of just 108 thousand over the same period.

Update to strategic view

FED FUNDS: The June employment report gives us little reason to change our expectation that the funds rate will be hiked to 5.5% at the August FOMC meeting. Our call for that to be the end of the hiking cycle is put at risk by the negative reaction of market price indicators of inflation expectations, in response to the Fed's more dovish recent tone.

[see Investment Strategy Dashboard]

For the Fed, however, the significance of this disparity between the two surveys likely pales in comparison to the wage data, which showed average hourly earnings up 0.5% last month and 3.9% over the past year. That's the highest rate of year-on-year wage growth in this expansion, and actually puts the growth rate at levels above those seen in the late 1990s, when the dreaded specter of "wage inflation" became a rallying cry in the Fed's deflationary tightening campaign. Obviously, we're a long way from a repeat of that disastrous episode. Quite the contrary, the inflationary consequences of the Fed's overly aggressive correction of its earlier deflationary error remains the order of the day. From that perspective, we see these wage gains as another factor compelling a "right thing for the wrong reason" response from the Fed, in that it likely will augur against a premature end to this policy cycle.



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forward-looking market prices such as commodities and the dollar, even the hint of a pause in last Thursday's FOMC release was enough to heighten the risk of serious inflation error, with gold jumping from below $580 to above $630. Behavior of these market price indicators suggests that participants in these sensitive markets were entirely unconvinced by the Fed's rationale that a moderation of growth from its "quite strong" levels of the past several months "should help to limit inflation pressures." For good reason. Despite the near unanimity of so-called "expert" opinion, there is, in fact, not a shred of empirical support for the proposition that slower growth is consistent with lower inflation. The opposite, in fact, is much more the case. As seen in the chart on the first page, inflation has always been highest when the economy was weakest. Conversely, and again flying in the face of the Phillips Curve/output gap conception which dominates conventional economic thinking, strong growth has tended to coincide with low to declining inflation. During the mid- to late-1990s, when real GDP growth averaged close to 4%, inflation -- as measured by the GDP price deflator -- was 1.7%. From 1974 through 1982, on the other hand, real growth averaged 2% and inflation 7.8%.

At the moment, solid growth is accompanying a moderate increase in core inflation. It's now incumbent upon the Fed, however, to continue taking the action required to ensure that the bump up in inflation remains within the bounds of "moderate" -- say 3 to 3.5% year-over-year. Otherwise, it's a sure bet that an inflation breakout will prove to be highly damaging to growth -- both because inflation is economically corrosive in and of itself, and because the Fed will then have no choice but to resort to a destructive tightening in response.

BOTTOM LINE: After first spiking nearly $10 to just below $640 on release of the jobs data this morning, the price of gold fell back and in early afternoon trading was down about $3 on the day, at around $631. This is consistent with our view that June's seemingly weak- payroll growth is unlikely to convince the Fed that its task is yet complete. While bonds continued to catch a bid on the news, the interest rate futures market also took a second look and concluded it's not time for the Fed to go on hiatus. August fed funds futures are priced for an 84% chance of an August move to 5.5%, coinciding with our view that this rate-hiking cycle has at least one more step to come. Will that one more step be the end? We surely thought so a month ago, when the market price indicators such as gold were responding so affirmatively to evidence of the Fed's heightened inflation vigilance. But as the Fed has moderated its hawkish tone, and the indicators have substantially reversed, the risk has gone up that a single additional rate hike now will not be sufficient to truly contain inflation expectations, and that more hikes further down the road will be necessary. TM