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TRENDMACRO LIVE!

On the September Jobs Report

Friday, October 3, 2014

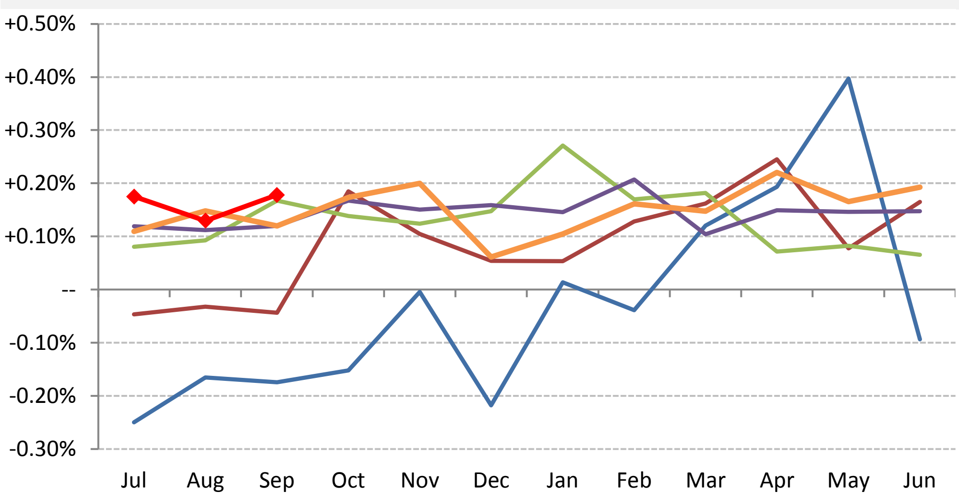
Donald Luskin

Bad news revised away -- and more fake fuel for the narrative that the Fed will tighten.

This morning's Employment Situation report was a blockbuster -- with 248,000 payrolls gained, versus expectations of 210,000, and that with huge upward revisions of 38,000 to last month's dismal report and 31,000 to the report from two months ago. In terms of month-over-month percentage gain for payrolls, this was the best September since the end of the Great Recession (please see the chart below).

- *Not at all bad for the fifth year of a business cycle expansion.*
- *But from the Fed's point of view, today's numbers still confirm that much slack remains in the labor market. They will do nothing to deflect plans to keep the funds rate at zero for a "considerable time" and then below normal virtually forever* (see "On the September FOMC" September 17, 2014).
- The unemployment rate fell from 6.1% to 5.9% largely because the labor force shrank by 97,000 persons -- the result of 232,000 more employed and 329,000 fewer unemployed (see "Data Insights: Jobs October 3, 2014).
- Long-term unemployment fell by 92,000, suggesting the possibility that most of the drop-outs from the labor force have been

Payroll growth MOM, starting July



Source: BLS, TrendMacro calculations

Update to strategic view

US MACRO, FX, US FED, ECB, BOJ: A very strong report, with a big upside surprise in payrolls despite strong upward revisions of the past two months' disappointing data. The strong dollar implies that markets believe this feeds into the narrative that the Fed will tighten, while other central banks are still easing. This is an error. Indeed, a stronger economy makes the Fed effectively looser, and as the economy continues to strengthen it will get looser for a "considerable time" until liftoff from the zero-bound, and then the funds rate will stay below normal virtually forever under "the Yellen Rule." With the ECB and the BOJ still trapped deeply below the zero bound, the Fed is in fact the easiest among the large central banks.

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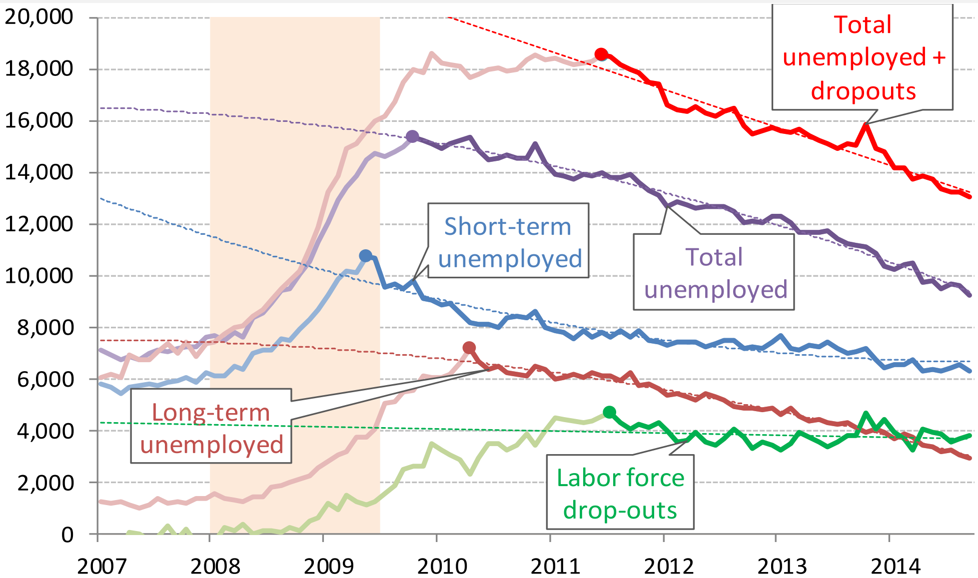
unemployed for more than 27 weeks. This is at least one month's hiatus in a strong trend toward the stabilization of the size of the labor force at the same time as long-term unemployment falls (please see the chart below, and "The Low Hanging Fruits of Our Labor" July 15, 2014).

- But the good news here is that at the same time, this morning's revisions show improvement in *short-term* unemployment, which has been worsening for two months (again, please see the chart below).

— Unemployed persons Thousands ····**Trend from ● peak**



Source: BLS, TrendMacro calculations

US stock and bond markets didn't immediately react especially strongly to what seems on the surface to be a blockbuster jobs report. But then again they didn't react strongly to last month's disappointment, either. Apparently markets expected today's revisions all along, as we did (see "On the August Jobs Report" September 5, 2014).

- The biggest reaction this morning has been in the dollar exchange rate, making a large move to the upside on top of a stellar rally begun in early May.
- We find this reaction to be not entirely sensible.
- It fits in with the narrative that the US economy is accelerating while the rest of the world sputters -- and the theory of exchange rate movements that currencies in faster-growing economies ought to strengthen.
- And it fits in with the narrative that the Fed is poised to tighten, while the central banks of Europe and Japan are easing -- and the theory of exchange rate movements that currencies in tighter-money economies ought to strengthen.
- Even granting these economic and monetary policy narratives, our many years of observing exchange rates does not confirm that

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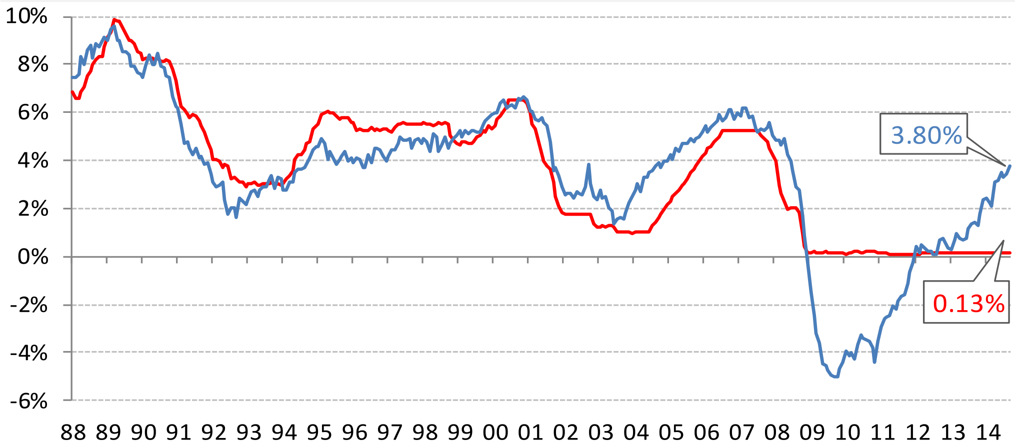
these theories of exchange rate movements hold true with any reliability.

- That said, we do not grant the underlying narratives -- at least not the monetary policy narrative that the Fed is tightening.
- In fact, the Fed is easing every day, and the more the US economic data improves, the more the Fed is implicitly easing.
- *For example, this morning's improvement in unemployment from 6.1% to 5.9% shifts the Taylor Rule reference-point for the fed funds rate from 3.48% to 3.80% (please see the chart below) -- yet the funds rate was zero before the jobs data was released and is still zero after it was released. <u>So effectively the Fed has eased this morning</u>.*

Yellen's Taylor Rule (per Rudebusch 2009) **Actual funds rate**
Rule: 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: FRBSF, BLS, BEA, CBO, TrendMacro calculations

- Indeed, the Fed will be even easier after a "considerable time" when, probably mid-2015, the funds rate is hiked from today's range of zero to 25bp to a higher range of 25 to 50bp. Yes, at that instant it will be a "tightening" versus the instant prior -- but versus today, assuming that unemployment continues to drift lower, which will drive the Taylor Rule reference-point higher, the policy will in fact be considerably easier.
- And from there it will stay easy virtually forever, though no longer at zero. This is what we call "the Yellen Rule," enshrined repeatedly in a 38-word sentence that first appeared in the March FOMC statement, Yellen's first FOMC as chair. It has recurred verbatim in her four subsequent FOMC meetings -- April, June, July and September. Here are the 38 words, with the critical policy intention called out in red:

The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

- With "the Yellen Rule" in place, we don't see why the Fed will be in any tighter a position than the European Central Bank or the Bank of Japan going forward. Yes, the ECB and the BOJ are still doing large-scale asset purchases, but that's only because they are trapped below the zero-bound on interest rates, and have LSAPs as a last resort -- indeed, they are engaged in them entirely because, for them, a zero interest rate is too tight.
- Remember, the Fed was in that situation in the Great Recession and the first years of its aftermath, when the funds rate could not go below zero, yet the Taylor Rule reference-point was prescribing a funds rate as low as negative 5%.
- The Fed's blessing is that the US economy looks like it is strengthening to a point at which policy can emerge from the zero-bound. That means the Fed can, if it wishes, effectively be looser than the ECB or the BOJ -- and "the Yellen Rule" means the Fed most definitely wishes.

Bottom line

A very strong report, with a big upside surprise in payrolls despite strong upward revisions of the past two months' disappointing data. The strong dollar implies that markets believe this feeds into the narrative that the Fed will tighten, while other central banks are still easing. This is an error. Indeed, a stronger economy makes the Fed effectively looser, and as the economy continues to strengthen it will get looser for a "considerable time" until liftoff from the zero-bound, and then the funds rate will stay below normal virtually forever under "the Yellen Rule." With the ECB and the BOJ still trapped deeply below the zero bound, the Fed is in fact the easiest among the large central banks.