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TRENDMACRO LIVE!

On the October Jobs Report

Friday, November 6, 2015

Donald Luskin

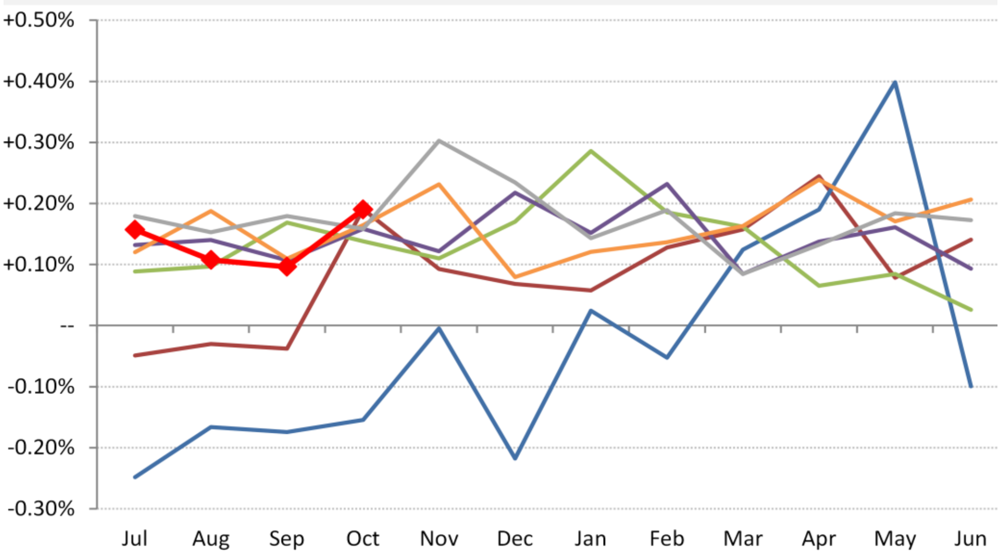
A big contradiction to our recession call. Liftoff now seems certain -- but likely still a mistake.

This morning's October Employment Situation report is certainly a contradiction to our belief that the economy has been slipping into a small recession (see, among many, "Another 'Reverse Oil Shock'?" Tuesday, July 28, 2015). But it is inconsistent with much other data that confirms our view. Credit conditions have eased only slightly, ex-energy forward earnings have been slipping, and we have seen no improvement in indicators of CAPEX or inventories. Let's keep an open mind: with oil prices having bottomed (see "Oil's Hard Road Forward" October 5, 2015), the force behind our recession call -- too-low oil prices -- has stopped making things worse, opening the way to potentially rapid recovery.

With 271,000 new payrolls, on top of net upward revisions to August and September's reports, the headline was a huge upside surprise to the consensus at 185,000. It ties for the best October since the end of the Great Recession (please see the chart below).

- *It comes on the heels of two of the worst months (again, please see*

Monthly payroll growth in post Great Recession expansion, starting July
2009-10 10-11 11-12 12-13 13-14 14-15 2105-16



Source: BLS, TrendMacro calculations

Update to strategic view

US MACRO, US FED, US STOCKS:
A big upside surprise, and just what Yellen was looking for to justify December "liftoff." Obviously, the probabilities have now shifted very strongly in that direction. This puts a lot of pressure on our call for a small recession. Perhaps with oil having bottomed, we've seen the worst. But many growth indicators still look recessionary to us, and there remains time for other data releases to keep the Fed on hold. With long-term inflation expectations about as bleak as they were in the Great Recession, and with the labor force participation rate so low -- and with widening spreads and the resurgent dollar having tightened credit conditions considerably -- we can't see what the Fed's hurry is. With stocks having rallied considerably from the August lows, we don't see how we can avoid some degree of retrenchment here.

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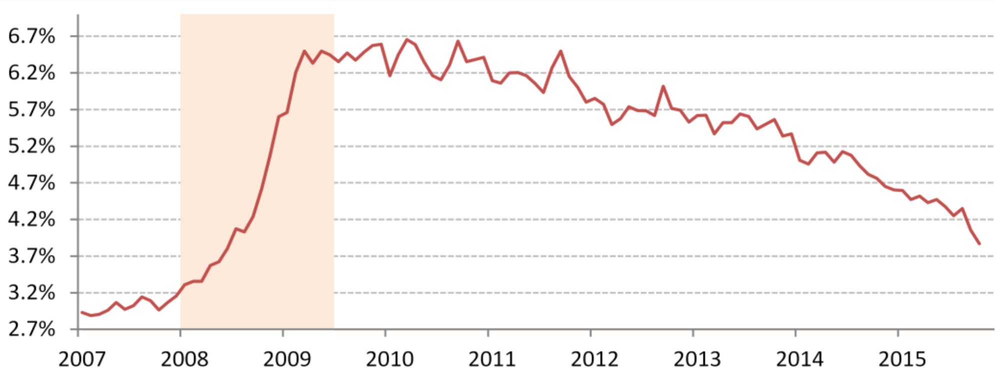
the chart below) -- so let's not judge too quickly.

- *But obviously, and setting aside for the moment whether it is the right thing to do, this strongly raises the likelihood of the Fed's "lift off" at the December FOMC meeting.*

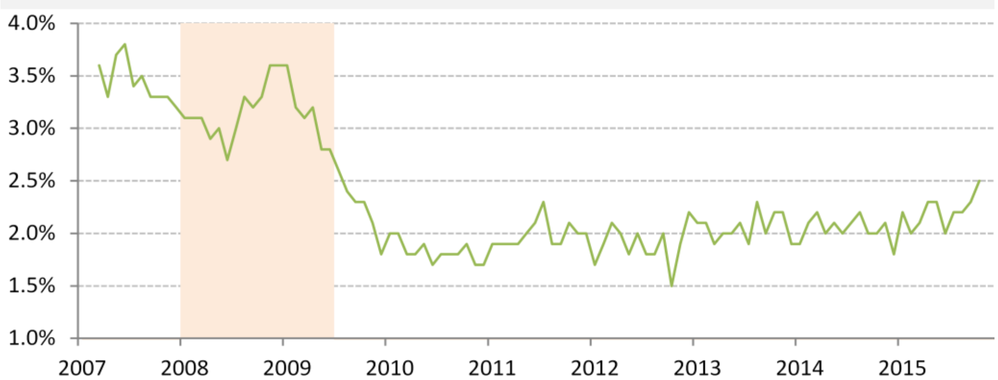
Let's look at it from the Fed's perspective. There's real improvement here in elements they watch most closely.

- The portion of the labor force working part-time (but who would prefer full-time work) -- a factor Fed Chair Janet Yellen often cites as key evidence of remaining slack in the labor force -- fell sharply in October, to new cycle lows (see "Data Insights: Jobs" November 6, 2015, and the chart below). *Okay, but's that's still well above the levels of the prior business cycle expansion.*



Source: BLS, TrendMacro calculations

- Average hourly earnings -- a key indicator among some Fed officials of so-called "wage inflation" -- grew at a robust 0.4% rate on the back of no growth at all last month. *Okay, but on a year-on-year basis it's not even back up to where it was at the trough of the Great Recession, and far below the levels of the prior business cycle expansion* (please see the chart below).



Source: BLS, TrendMacro calculations

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[About us]

Recommended Reading

Text of the Trans-Pacific Partnership
November 5, 2015

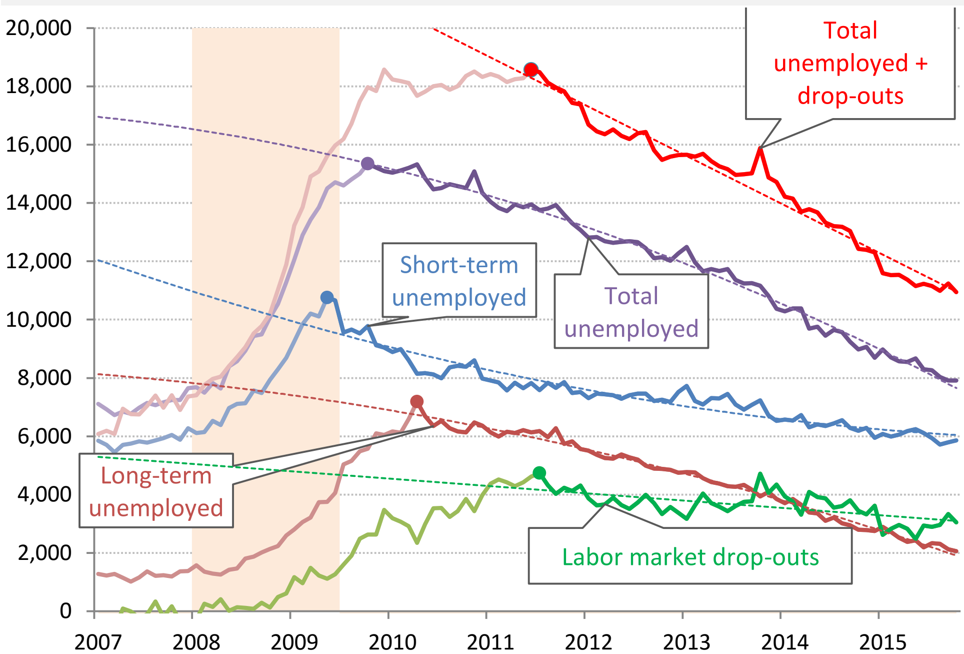
Cycling Li-O2 batteries via LiOH formation and decomposition
Tao Liu1, Michal Leskes, Wanjing Yu, Amy J. Moore, Lina Zhou, Paul M. Bayley, Gunwoo Kim and Clare P. Grey
Science
October 30, 2015

[Reading home]

Some of the labor market indicators we follow most closely improved as well.

- The civilian labor force expanded by 313,000 persons. That leads us to calculate that the cumulative trend-adjusted number of persons who have dropped out of the labor force since before the Great Recession fell by 287,000 -- the first move in the right direction since May (please see the green line in the chart below).
- That said, the number of unemployed persons fell by only 7,000. While 67,000 of the long-term unemployed (27 weeks or longer) found work, 60,000 more persons entered the ranks of the short-term unemployed (see the brown and blue lines, respectively, in the chart below).

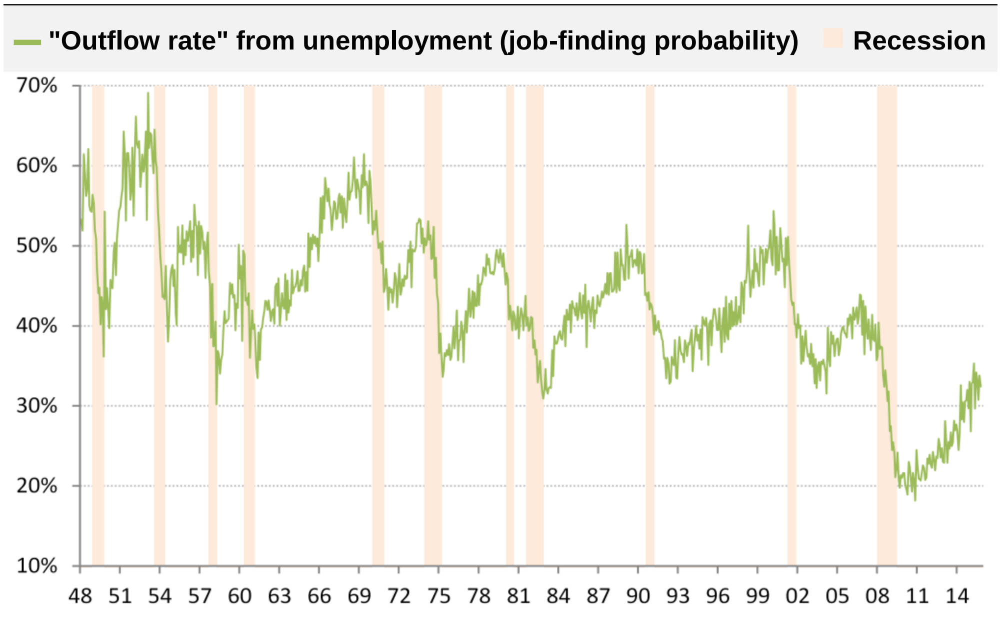
Unemployment and drop-outs — Level • Peak ···Trend from peak
SA, thousands Underemployment = labor force vs 20-year trend **Recession**



Source: Bureau of Labor Statistics, NBER, TrendMacro calculations

- Accordingly, the "outflow rate" from unemployment -- think of it as the probability of an unemployed person getting a job within a given month -- fell from 33.8% to 32.4%. While this is a significant improvement from the worst levels of the Great Recession, it only brings the labor market back to levels which, in the past, have been associated with deep recession troughs (please see the chart on the following page).
- *Thus the key issue in the US labor market since the onset of the Great Recession remains very much in place -- the inability of the economy to generate new jobs.*

With that in mind, and with survey- and market-based indicators of long-term inflation expectations at levels similar to where they were during the Great Recession, we really have to wonder why the Fed is in such a hurry



Source: Per Shimer (2005), BLS, TrendMacro calculations

to "lift off." True, in December it will have been seven years at zero -- but that doesn't mean it isn't still too soon to declare "mission accomplished."

- The Fed appears to be driven by its long-standing attachment to the Phillips Curve: the idea that full employment leads to inflation.
- In this case, with the labor market in such a paradoxical state -- a low headline unemployment rate, but at the same time a very low labor force participation rate -- even devout believers in the Phillips Curve ought to be questioning how to benchmark "full employment."
- But the larger issue is that the Phillips Curve has proven, in the laboratory of the real world, to be a failed experiment. It doesn't account for the simultaneous high inflation and high unemployment of the 1970s, nor the low inflation and low unemployment of the 1980s. For that matter, it doesn't explain present conditions -- apparently low unemployment and virtually no inflation at all.
- As Federal Reserve Board Governor Lael Brainard put it in a speech in October:

> I do not view the improvement in the labor market as a sufficient statistic for judging the outlook for inflation. A variety of econometric estimates would suggest that the classic Phillips curve influence of resource utilization on inflation is, at best, very weak at the moment.

- But Brainard is not an academic economist like Yellen, Vice Chair Stanley Fischer, or New York Fed President William Dudley -- all of whom cling to the Phillips Curve. For example, explicitly referring to Brainard, Yellen said in Q&A following her House testimony on Wednesday, "I believe… with an improving labor market and transitory factors fading, that inflation will move up to two percent."

- To be sure, modern Keynesians like Yellen hedge their bets on the Phillips Curve in sophisticated ways. In the same September speech during which she became visibly ill, Yellen expounded at length on her model for thinking about inflation, finally identifying it as the "expectations-augmented Phillips Curve."
- The last time I ever talked to Yellen, I had the impertinence to disagree with her on the Phillips Curve, citing history's many contradictions of it. She said, "Well, the best evidence is that the Phillips Curve is flat." She was not happy when I retorted that a flat curve is no curve at all.

But right or wrong, it seems inevitable right at this moment that "liftoff" will come in December. We still think there's a real chance that continued soft data coming from what we still think is the first-ever recession caused by too-low oil prices could derail it. So we acknowledge the basic directional correctness of Fed funds futures' implied "liftoff" probability of 70%, but we think it exaggerates the actual probability.

- How big a mistake would a December "liftoff" be? On the face of it, perhaps not much. For that matter, there are many smart people -- including quite a few of our clients -- who think the Fed has made matters worse for quite a while by not having "lifted off" months ago, and would greet a December "liftoff" as a very good thing.
- We aren't passionate on the subject, but if we were the FOMC we would not do it. This morning's jobs report notwithstanding, we see the bulk of our growth indicators pointing the wrong direction. This is not the time to tighten monetary policy.
- While credit spreads have narrowed a bit from their worst levels, they are still far tighter year-on-year. And the dollar approaching the March highs adds to the tightening of financial conditions. Why does the Fed need to add to that?
- With global equities having rallied significantly during two months over which it seemed the Fed would stay on hold in December, we don't see how it can't be time for a retrenchment -- although we would be surprised if we breached the August lows.

Bottom line

A big upside surprise, and just what Yellen was looking for to justify December "liftoff." Obviously, the probabilities have now shifted very strongly in that direction. This puts a lot of pressure on our call for a small recession. Perhaps with oil having bottomed, we've seen the worst. But many growth indicators still look recessionary to us, and there remains time for other data releases to keep the Fed on hold. With long-term inflation expectations about as bleak as they were in the Great Recession, and with the labor force participation rate so low -- and with widening spreads and the resurgent dollar having tightened credit conditions considerably -- we can't see what the Fed's hurry is. With stocks having rallied considerably from the August lows, we don't see how we can avoid some degree of retrenchment here.