Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

TRENDMACRO LIVE!

On the April FOMC

Wednesday, April 25, 2012

Donald Luskin

The FOMC darkens its language, lightens its forecast, and does nothing -- yet.

Today's FOMC statement is almost word-for-word identical to the prior meeting's, with an ever-so-slightly darker shading -- all of which derives from the elimination of a few key words.

- Saying the labor market has only "improved" is a downgrade from "improved further" -- and "notably" no longer describes how the unemployment rate has fallen -- reflecting last month's disappointing jobs report (see "Bad Friday for Jobs" April 9, 2012).
- And the statement no longer says global financial conditions "have eased" -- though it repeats that they represent "significant downside risks."
- The largest number of new words in the statement concern inflation, which is now acknowledged to have "picked up somewhat" -- but this is now said to be "only temporarily," not just "temporarily."
- On the other side, the FOMC notes "some signs of improvement" in the housing sector -- but it repeats that it "remains depressed."

This is all rather confusing in light of today's FOMC member economic forecasts, which on average show upgrades for improvement in growth and unemployment. Nevertheless the statement's essentially unchanged stance is appropriate, since nothing much in the environment has changed. Yet seconds after the statement was published, gold dropped $15 in a single tick, as though this most liquidity-sensitive market were disappointed that QE3 wasn't announced today.

- Not a single economist in CNBC's Fed poll expected any such thing today -- and as of this writing, gold has more than recovered.
- Yet the Fed's "do nothing" stance today does fundamentally disappoint, because of the deep sense of anticipation and apprehension we all have -- that the Fed will, might, ought to "do something" in this economic environment that is so unlike any we've ever experienced.
- No matter what language the FOMC uses to skirt the issue, inflation is already at or above the Fed's official 2% target -- headline PCE inflation is up 2.3% year-on-year, and core is up 1.9%. On the face of it, this is a constraint to further easing.

Update to strategic view

US FED, US MACRO, US STOCKS, GOLD, COMMODITIES: The FOMC statement's outlook darkened somewhat, at the same time as the FOMC member's average economic forecasts brightened a bit. We think this shows the outsized influence of two key doves on the FOMC, who believe that continued fundamental distress in the labor market requires further easing, or at least maintenance of the Fed's already demonstrably loose posture. This is a cushion against downside economic risk, and a tailwind for stocks and commodities, especially gold.

[Strategy Dashboard home]

- And according to the version of the Taylor Rule that we know the Fed uses, unemployment has fallen sufficiently so that -- in combination with the inflation rates we just cited -- the Fed has been demonstrably easy since last October (see ["On the March FOMC"]() March 13, 2012).
- Yet the pressure to "do something" is very much alive and well both in the market and on the FOMC, especially among the small but highly influential covey of super-doves [Janet Yellen]() and [William Dudley]() both of whom made extravagantly dovish speeches the week before last (see ["A Glass of Snapple, Half Full"]() Friday, April 20, 2012).
- The outsized influence of these two doves probably explains the darker FOMC statement despite the more optimistic *average* forecasts by FOMC members.

The "do something" impulse comes from observing the labor market -- with all its political baggage in this election year. On the one hand it seems to have improved considerably -- measured by the fall in initial claims and the unemployment rate. But in fact, below the surface -- but close enough to the surface that everyone can at least sense it -- it remains fundamentally broken. By some measures, it has not improved at all from the worst moments of the Great Recession (see ["On the February Jobs Report"]() March 9, 2012).

The chart below -- it's confusing at first glance, but never fear, we'll explain it -- captures the paradox-ridden uniqueness of the challenge facing the

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

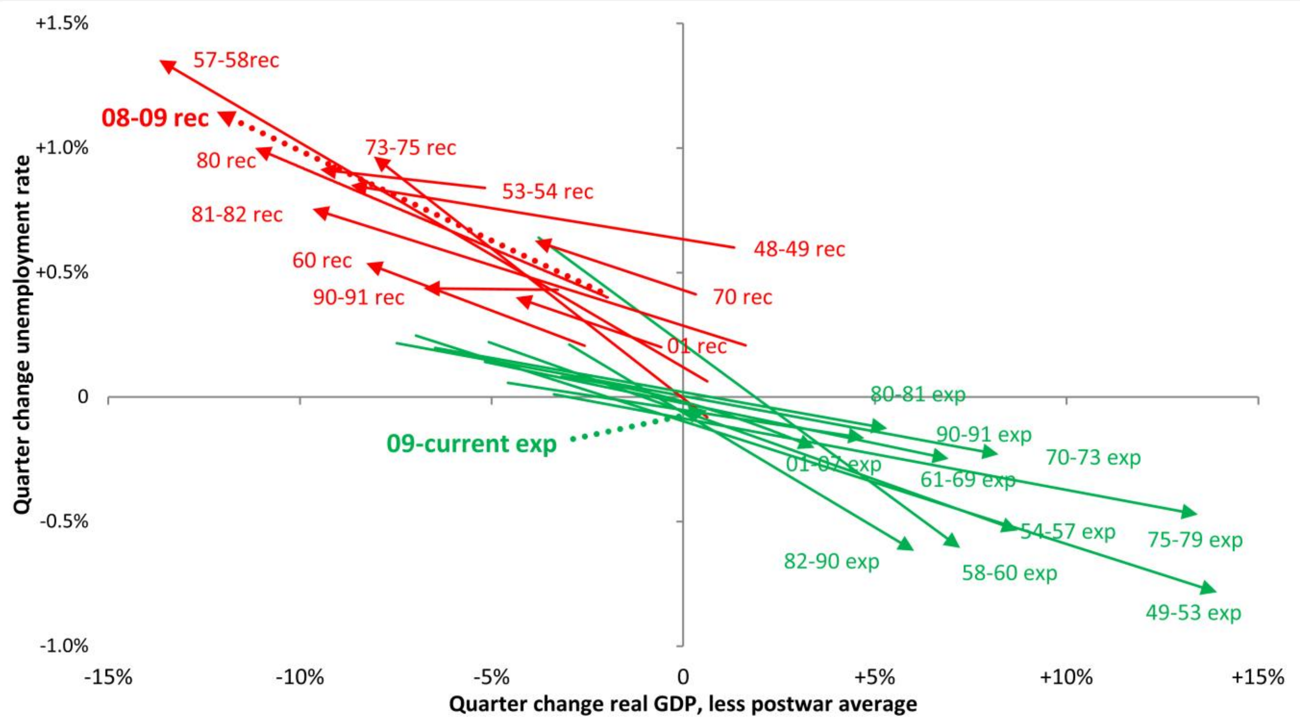
Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

Link between unemployment and above-trend growth → Expansions ← Recessions Linear trends



Source: BLS, BEA, NBER, TrendMacro calculations

Fed as it appraises the labor market.

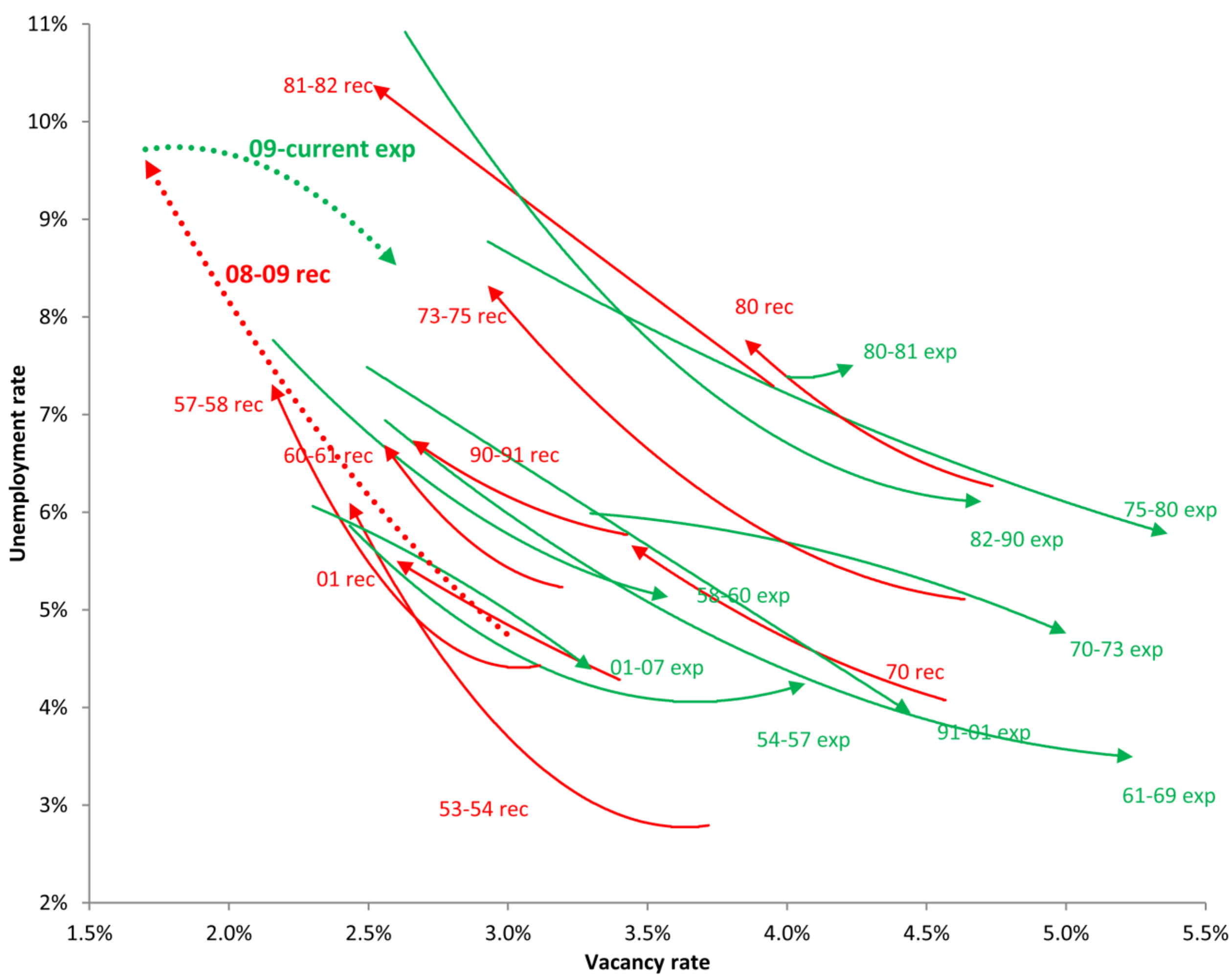
- For the first time in the post-war history of business cycles, the relationship between growth and jobs has turned upside-down: in this expansion, *falling* unemployment is correlated to *below*-trend growth (please see the green dotted arrow in the chart, pointing up and to the right).
- Typically in an expansion, falling unemployment is correlated with *above*-trend growth (in the chart, all the *other* green arrows point to the *lower* right). Typically, *below*-trend growth is correlated with rising unemployment in recessions (in the chart, please see the red arrows pointing to the upper left).
- This relationship is so common-sensical and has always been so reliable it has been enshrined as "Okun's Law." It is explicitly assumed in the Fed's statutory mandate "to increase production, so as to promote…maximum employment."
- If Okun's law is a compass that leads to jobs via growth, then it is one that is suddenly pointing south, not north.
- Why is this happening?
- **First,** in the Great Recession, the labor force underwent an historic shrinkage of 1.8 million persons -- people not "unemployed, but who totally dropped out of the labor market. Now after almost three years of expansion, 1.7 million have come back, leaving the labor force still 100,000 persons smaller. But over the same time, the working age population has increased by 6.9 million persons.
- With the labor force thus short by 7.0 million persons, above-trend growth creates *unemployment*, not employment, because it draws people back into the labor force -- and when they enter, they will generally start as unemployed job-seekers.
- Ben Bernanke mentioned this in today's post-FOMC press conference. It's the simple explanation for what he has described as the "puzzle" of Okun's Law.
- Thus higher growth increases the measured unemployment rate, and lower growth decreases it (as more persons drop out of the labor force in frustration). With this in mind, it's not so paradoxical that today's FOMC member economic forecasts downgrade 2012 growth at the same time as they expect better improvement in the unemployment rate.
- **Second,** the current recovery has not produced much above-trend growth for the labor market to respond to in the first place.
- Of the ten quarters of recovery reported so far, only three (Q4-09, Q1-10 and Q2-10) exhibited above average growth, and none of them even by as much as 1% on an annual basis.

For Yellen and Dudley the path is clear -- more QE will create more growth, and even if that raises the unemployment rate, at least more people will be in the labor force, and probably more will be working. For more eclectic thinkers, like Ben Bernanke, it's not so clear -- as we said, inflation has already risen to target and above, and the Fed is *already* easy, and has been for six months. From that perspective, the Fed has already done enough, and the economy has already responded as well as it's able to -- anything more would be counterproductive.

Another way of looking at the labor market gives some support to that point of view -- suggesting that there are fundamental structural changes going on in the economy that explain and justify a smaller labor force and a higher unemployment rate. It's the idea that the US labor force, as currently trained (at the high end) and compensated (at the low end), is not able to be employed in today's tech-driven and globalized economy.

The evidence for this most often cited is the "Beveridge Curve," which plots the relationship between unemployment and job openings. The basic idea is that in a recession, jobs become unavailable and the unemployment rate rises -- and in expansions, jobs become available and the unemployment rate falls. This is shown in the chart below -- again, confusing at first, but please bear with us.

Link between unemployment and job openings → Expansions ← Recessions Polynomial trends



Source: BLS, Conference Board normalized per Valletta (2005), NBER, TrendMacro calculations

- Most commentary on this has focused on the anomaly that in the present expansion, unemployment has stayed higher than it should in light of the increase in job openings (on the chart, note that the heavy dotted green arrow -- the present expansion -- is convex, while all the other arrows are concave).
- The idea is that unemployed workers don't have the right skills to take advantage of the job openings that are available.
- Maybe extended unemployment benefits reduce marginal incentives to become employed, so the unemployed do not take advantage of available openings, even if they are qualified.
- We think that building a *hawkish* case by focusing on this aspect of the present Beveridge Curve is to ignore the elephant in the room -- which, if it were perceived, actually makes a *dovish* case.
- For us, what jumps off the chart on the previous page is that the entire current expansion plots in the upper left -- that's where recessions live, not expansions.
- This is simply because, in this expansion, job openings have hardly grown at all. After almost three years of expansion, the level of job openings has only *risen* to the level where it normally *falls* at the worst of typical *recessions*.
- So as we've been saying, the key issue is that our economy is not producing new jobs (again, see "On the February Jobs Report").

The doves like Yellen and Dudley are focusing on the elephant in the room, believing that further easing can create more job creation. The hawks -- or just the more cautious doves like Bernanke -- are focusing on convexity of the present Beveridge Curve to argue that further easing won't help if the labor force is underqualified.

We continue to see the doves as likely to win this argument, especially in an election year in which Bernanke is politically weak (again, see "On the March FOMC"). At the slightest weakening in macro data, we think this will translate quickly into further easing. Even without that -- but barring a highly unlikely sudden improvement in the outlook -- we think this means the Fed does nothing to tighten for a very long time, even though it is already demonstrably loose. So we continue to think that this provides a cushion to any downside risks that may eventuate, and a tailwind for stocks and for liquidity-sensitive assets such as commodities, and especially gold.

Bottom line

The FOMC statement's outlook darkened somewhat, at the same time as the FOMC member's average economic forecasts brightened a bit. We think this shows the outsized influence of two key doves on the FOMC, who believe that continued fundamental distress in the labor market requires further easing, or at least maintenance of the Fed's already demonstrably loose posture. This is a cushion against downside economic risk, and a tailwind for stocks and commodities, especially gold.