Private Bank

Global Strategy: Bulletin

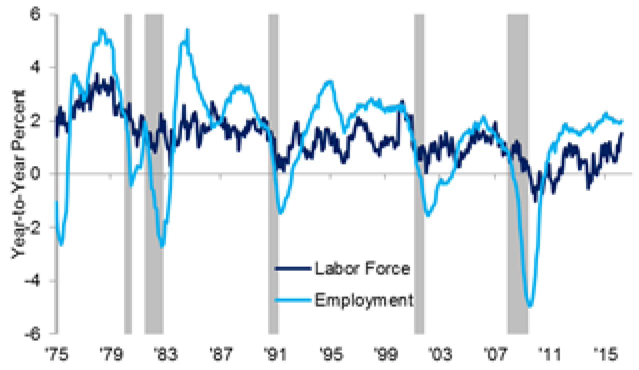
U.S. Labor Market Shows Both Growth and Growth Potential: Is Fed Policy Now a Pro-Cyclical Risk?

World Recoils from Fed Chair Yellen's Outstretched Hand

- World financial markets seem to be in a state of confusion after strong economic data suggested a hopeful outlook for world growth just after key central bankers reminded markets of their dependence on easy monetary policy. U.S. data, in particular, suggested a future economic peak could be more distant than we have feared.
- U.S. labor force growth may have reawakened after an unusual six-year period of weakness. However, this suggests a higher "neutral" Fed funds rate over the long-term, even as near-term slack in labor markets is more abundant. (The U.S. unemployment rate rose in March despite strong hiring.)
- Fed Chair Yellen's recent comments focused on downside risks and the role that reduced U.S. monetary policy tightening expectations have played in stabilizing world financial markets. We are concerned that the asymmetric bias to U.S. policy may foster financial risks that will only be evident in time. These include sustaining financial imbalances abroad that U.S. policy accommodates.
- Despite our long-term concerns, the latest data suggests there's more room for economic optimism near-term.

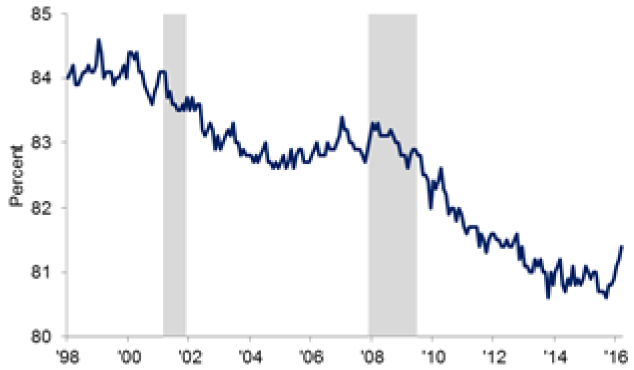
On one count, U.S. economic data seem to be proving Fed Chair Yellen right: After six years of above-trend gains in hiring, coupled with a strangely morbid labor force, U.S. job seekers are finally returning. If the trend of the past six months persists, a more enduring and possibly stronger U.S. economic expansion could result (see figures 1-2).

Figure 1. U.S. Labor Force and Employment Growth Y/Y%



Source: Haver Analytics as of April 1, 2016.

Figure 2. Prime Age Labor Force Participation Rate



Sources: Haver Analytics as of April 1, 2016. Note: Prime age is 25-54.

In recent years, we have highlighted the sharp decline in U.S. unemployment as driven in part by an unusually poor growth rate of the prime-aged labor force. *Lasting expansions require growth in resources, not just greater use of existing resources*. Six years of improving labor demand seemed too long a wait for a sudden reawakening. We may have been wrong after all.

Significant demographic constraints on U.S. employment still loom ahead. The 215,000 rise in hiring just reported in March leaves the trend of job gains above the growth rate of the total U.S. adult population – centenarians included. This can't be sustained forever. The well of discouraged, sidelined job seekers is also not infinite. Yet we have to again acknowledge this long-awaited supply-side improvement in the U.S. outlook, or at least tentative signs of it (please see our latest *Quadrant March 21, 2016:* Seek Compensation for Volatility). While faster labor supply growth can generate faster demand growth, it might also mean a future U.S. economic peak is further off than we feared.

In Search of "Neutral"

The growth rate of the labor force and productivity dictate the long-run growth rate that an economy can sustain. This "potential growth rate" of an economy is linked to the "neutral" real interest rate.

As Fed Chair Yellen describes the neutral rate: "the level of the real federal funds rate that would be neither expansionary nor contractionary if the economy was operating near its potential."

In recent Federal Reserve communications, this neutral rate was described as "near zero" at the moment, but likely to rise over time as all sorts of arguable headwinds dissipate. By the Fed's favored inflation measure, this would mean a nominal Fed funds rate now near 1.7% would be "neutral." Meanwhile, the median forecast of Federal Open Market Committee members for the long-term "normal" Fed funds rate is even higher, 3.3%.

Our question is, if the Fed funds rate is now appropriate at 0.375%, what sort of economic paradise would we have to ascend to for the rate to reach 3.3%? While new signs of U.S. growth slack weigh against any near-term concerns, we have to wonder if the Fed's highly accommodative monetary policy has moved from a counter-cyclical one to a pro-cyclical risk. This is particularly the case when the Fed seems so concerned about its impact outside the U.S. Events of the past two decades suggest that delaying U.S. monetary policy adjustments can ultimately add to macro-level financial risks. Some previously untested risks might also arise as central banks actively seek to boost inflation over time.

Confusion Over Fed Resumes in World Markets

With strong data reported in both the U.S. today and a good sample of other economies (most national manufacturing purchasing managers reports rose), world financial markets seem to be in a state of confusion trying to digest the Federal Reserve's new policy path. Almost across the board, financial markets *weakened* on strong data today. We are inclined to think this relationship is temporary. However, Fed Chair Yellen's latest, highly cautious remarks on the path of U.S. interest rates appears to have refocused market attention on monetary policy rather than growth fundamentals.

Wasn't the Rising Dollar a Problem?

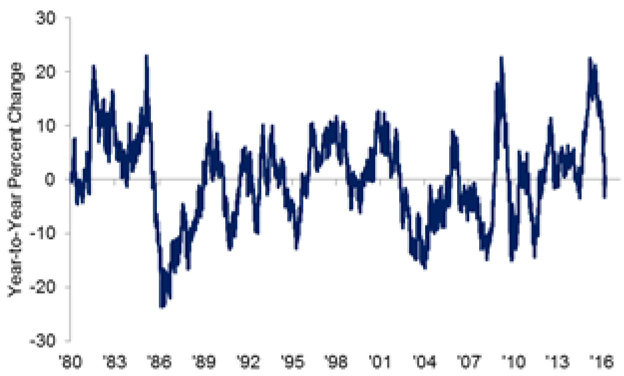
The U.S. dollar's powerful rally over the past two years has proven to be a major complication for world policymakers seeking a smooth transition away from the crisis years (see figure 3). It has impacted on the funding costs and debt burdens of external borrowers in U.S. dollars. It has increased the economic and financial vulnerabilities of China, which has long pegged it's currency to the U.S. dollar to some degree. It has contributed to the commodity price collapse and subsequent economic weakness of petroleum exporters.

With all this in mind, world markets seem quite tentative on the remarkably dovish view expressed March 29 by Fed Chair Yellen which has sunk the U.S. dollar. As she noted: "To the extent that recent financial market turbulence signals an increased chance of a further slowing of growth abroad, oil prices could resume falling, and the dollar could start rising again. And if foreign developments were to adversely affect the U.S. economy by more than I expect, then the pace of labor market improvement would probably be slower."

"Given the risks to the outlook, I consider it appropriate for the (Federal Open Market Committee) to proceed cautiously in adjusting policy…if the expansion was to falter or if inflation was to remain stubbornly low, the FOMC would be able to provide only a modest degree of additional stimulus…"

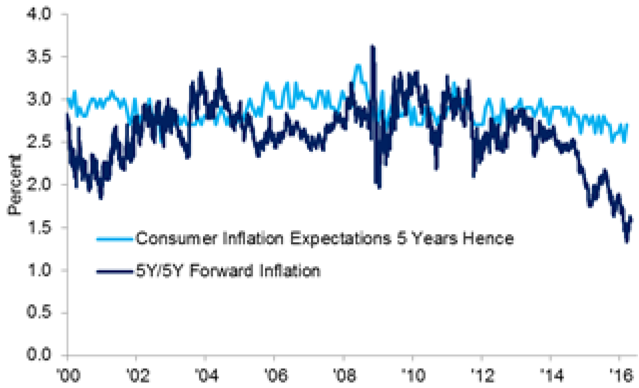
Notably, Fed Chair Yellen expressed concerns that inflation expectations have become "unanchored" and too low (see figure 4). As she says, "Unfortunately, the stability of longer-run inflation expectations cannot be taken for granted." This comment seemed to suggest the Fed will seek to actively boost trend inflation rather than assume it will rise back to the (oh so precise) 2% target that comprises the Fed's base case assumption. Suddenly, we can't quite argue with the confusion.

Figure 3. Trade-Weighted Nominal U.S. Dollar vs Majors



Source: Haver Analytics as of April 1, 2016. Note: Countries whose currencies are included in the major currencies are the Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden. The Euro Area includes Germany, France, Italy, Netherlands, Belgium/Luxembourg, Ireland, Spain, Austria, Finland, Portugal & Greece.

Figure 4. Bond Market Expected Inflation Rate 5-Yrs Hence vs Surveyed Consumer Inflation Expectations 5-Yrs Hence



Sources: Haver Analytics as of April 1, 2016.

Our Takeaway:

We suspect Yellen's comments were aimed at broadening global growth support when, at least at some points previously, central banks were playing a zero-sum game of currency depreciation. We are concerned, however, that the asymmetric bias to U.S. policy may foster financial risks that will only be evident in time. These include fostering financial imbalances abroad.

Fed Chair Yellen – and other central bankers around the world – made statements and took steps to remind markets of our dependence on them. Despite our long-term policy concerns, fortunately, the latest data suggests there's more room for economic optimism near-term.

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