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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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A THOUGHTFUL AND THOROUGH YELLEN

Fed Chair Janet Yellen opened the annual end-of-summer Jackson Hole confab on Friday morning with a speech on the labor market. Despite superficial reactions that the Chair "broke no new ground" or that her comments were "a bit more hawkish than expected," we viewed her remarks as a thoughtful and thorough overview of labor market dynamics and their implications for monetary policy.

The backdrop: the US economy is closer to the Fed's policy targets than a year ago. On the inflation front, core measures of inflation appears to have stabilized from very low levels and may be poised to head higher, back toward the Fed's 2% target. On the unemployment front, the U-3 unemployment rate is now 6.2% versus 7.3% a year ago. As a result, the Fed is winding down its asset purchase program and thinking ahead to rate hikes. How long until that much anticipated day? It depends.

For Yellen, the key question for policymakers is how much slack remains in the US economy–more slack and rate hikes arrive later, less slack and rate hikes arrive sooner. In Friday's speech, she posed the question: "What portion of the decline in labor force participation reflects structural shifts and what portion reflects cyclical weakness in the labor market?"

Her answer was both. After first noting that "a portion of that decline clearly relates to the aging of the baby boom generation," she quickly reminded her audience that the "pace of decline accelerated with the recession," reflecting "other reasons, including worker discouragement," which is "most directly the result of a weak labor market."

Many of those discouraged workers account for much of the slack and may rejoin the labor force as the economy heals. And there is some evidence that this reversal is underway. The labor force participation rate (LFPR) bumped up to 62.9% in July and is roughly flat over the last year after falling sharply in the recession. The stabilization of the labor force could suggest a modest tightening in employment–a welcome improvement. In Yellen's words, "the flattening out of the labor force participation rate since late last year could partly reflect discouraged workers rejoining the labor force in response to the significant improvements that we have seen in labor market conditions. If so, the cyclical shortfall in labor force participation may have diminished."

On its face, though, low wage growth still corroborates the thesis that ample slack remains in labor markets. In Yellen's words, "Over the past several years, wage inflation, as measured by several different indexes, has averaged about 2 percent, and there has been little evidence of any broad-based acceleration in either wages or compensation." Even further, "this pattern of subdued real wage gains suggests that nominal compensation could rise more quickly without exerting any meaningful upward pressure on inflation."

So not only does sluggish wage growth point to slack, an acceleration in wage pressures wouldn't necessarily sound the alarm on overall price pressures (i.e., inflation).

But Yellen proceeded along this line of argument with caution. She cited several reasons why wages may be depressed that have to do with forces *other* than economic slack. Wage growth could be a "misleading signal of the degree of remaining slack". For example, price pressures could emerge before expected because "people who have suffered long-term unemployment–along with, perhaps, those who have dropped out of the labor force but would return to work in a stronger economy–face significant impediments to reemployment."

In her thoughtful and thorough speech, there is an important lesson for investors: ignore analysts telling you that a single metric will drive Fed policy or that the "Fed intends to do X". The path ahead very much depends on the evolution of the data. Further, remember that "slack" is difficult to measure in real-time. Buried in a footnote to the speech, Yellen counsels, "For convenience, the analysis here is presented as if cyclical factors and structural factors can be neatly delineated. In reality, the line between the two may be indistinct."

Indeed, reality is far messier than many analysts would have you believe. For now, the FOMC has concluded that "substantial underutilization of resources [slack]" remains. Given the preponderance of the evidence, we tend to agree. But, the Fed Chair is not entirely sure what is going on. Investors shouldn't be too confident either.