Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

MAY 23, 2014

2% IS NOT A CEILING

Spring has sprung but the economic data still lack momentum. That, coupled with comments from central bankers, probably mean that a fed funds rate hike is still more than a year away.

Despite a bounce in new home sales in April and upward revisions to March data, the average annual sales rate for the first four months of 2014 is down from the same period a year ago by 3.3%. Existing (or resale) home sales also rose month-to-month in April but are down more than 10% from last summer. Even putting aside weather-related issues, the housing data continue to disappoint forecasters (including the Fed) who had penciled in a pick-up in activity this year.

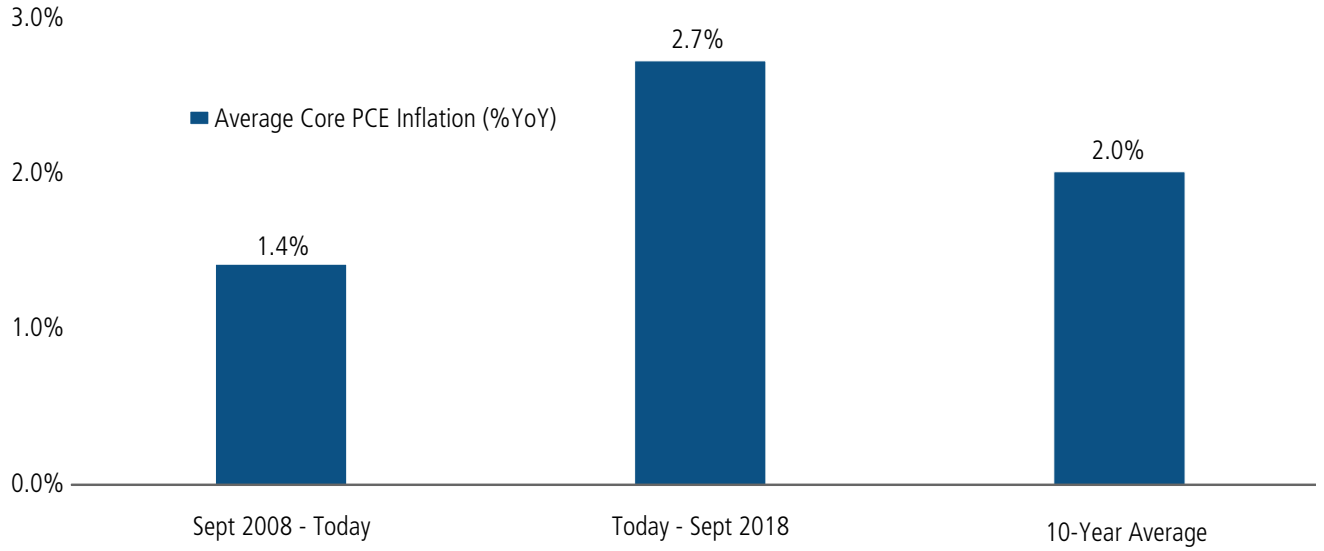
Speaking of the Fed, the key battle within the FOMC revolves around the amount of "slack" in the economy. Despite some back and forth, minutes from the April FOMC meeting relayed that most participants admit "there is more slack in the labor market than is captured by the unemployment rate alone" and that "low nominal wage inflation… [is]…consistent with slack in labor markets."

In a speech this week, New York Fed President William Dudley went a step further than some of his Fed colleagues, stating that discouraged workers account for "a couple of percentage points" of the decline in the labor force participation rate (LFPR). If true, this suggests a significant amount of slack not captured in the official unemployment rate. By our calculations, the difference between a 62.8% LFPR and a 64.8% LFPR equals roughly 5 million workers.

Meanwhile, on the other side of the dual mandate, Minneapolis Fed President Kocherlakota pointed out that core inflation as measured by the personal consumption expenditures (PCE) index excluding food and energy prices, has averaged 1.4% over the last five years. Even if core PCE drifts back to 2% as most forecasters expect, Kocherlakota noted a "return to 2 percent [could] take a long time--possibly on the order of four years." Further, he suggested that allowing time for core inflation to persist above 2% would be appropriate given the low inflation experienced in recent years. Core inflation has been below 2% for 64 of the last 66 months dating back to September 2008. In fact, as we show in the attached slide, core PCE would need to average 2.7% year-over-year from today until September 2018 just to bring the 10-average back to 2%. Remember: the FOMC's 2% inflation "target" is a moving average, not a ceiling.

Oddly, while FOMC members worry more about labor market slack and lack of inflation, market participants fret that Fed will quickly pivot. The latest Primary Dealers Survey still pegs Q2 2015 as the appropriate timing of the first rate hike. In our view, lack of data momentum, labor market slack and low inflation seem at odds with an early rate hike.

WHAT THE FED NEEDS ON CORE PCE INFLATION TO HIT THEIR 2% TARGET OVER THE DECADE FOLLOWING THE FINANCIAL CRISIS



Source: Bureau of Economic Analysis, Payden Calculations