Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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LSAPs MAY END, ZIRP HERE TO STAY

On Friday, we learned that the US economy added 204,000 jobs in October, a major beat of consensus expectations for 120,000. Despite the positive headlines, the Fed will wait for November data before drawing conclusions and you should, too. One report is not enough to shift policy nor should it alter your investment outlook.

Unemployment, as measured by the Household survey, increased on the month to 7.3%. However, we think investors should ignore the Household survey for this month, beset as it is by substantial statistical noise. In October's report, 448,000 respondents reported themselves as "temporarily laid" off—among them were the federal employees affected by the government shutdown.

By contrast, nonfarm payroll employment in the Establishment survey grew 204,000. Including recent revisions, the 6-month average is now +174,000 and the 3-month average is +202,000 (see chart below). Seen in that light, the payroll trend looks much better than before this report. Seen another way, though, October's report brings only more of the same. Payroll growth has been stuck in the 150,000-200,000 range for more than two years. When reading the monthly jobs report, the most important question to ask yourself: "What's the underlying trend of job growth"? We continue to see moderate job growth.

Does this month's data change the debate on tapering? We think the Fed would like to see sustained evidence of 200,000/month on payrolls to start tapering. Today's report tilts the scale in that direction. But the other half of the Fed's mandate, inflation (1.2% year-over-year in today's personal income and outlays report) needs to move back toward 1.5-2.0%, having averaged 1.2% for the last six months. The 2% level is a target, not a ceiling. Concerns about persistently low inflation may give pause to those eager to taper.

All things considered, our base case of continued moderate economic growth, moderate job growth (150,000-200,000), low inflation, and elevated unemployment remains unchanged. Regardless of when it arrives, tapering does not mean tightening. The Fed's balance sheet will continue to expand well into 2014 after the initial reduction in the pace of asset purchases. Moreover, FOMC policymakers have insisted that a long interval of time should pass from the end of asset purchases to the first change to the target fed funds rate. Along with 12 of 17 FOMC members, we do not expect a rise in the fed funds rate before 2015, at the earliest.

As a result, the Fed's focus returns to convincing the market that an end to LSAPs (Large Scale Asset Purchases/QE) is not the end of ZIRP (zero interest rate policy). To bolster their argument, the Fed could sharpen its forward rate guidance (the 6.5%/2.5% "thresholds" for fed funds) by lowering the unemployment threshold, raising the inflation threshold and/or instituting an inflation floor. The goal: deliver the message that the fed funds rate will remain low until certain conditions are met. Of course, the ultimate problem with this approach is that it assumes the market understands the Fed and finds the Fed's promise credible. The neat trick played by QE was not that it boosted job growth, but rather it helped convince the market that interest rate hikes were still a long way off. Can the Fed shape interest rates without LSAPs? That's the challenge for 2014.

TOTAL PAYROLL EMPLOYMENT – 3 MONTH MOVING AVERAGE