Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 3, 2014

PATIENCE IS A VIRTUE

Data released today from the Bureau of Labor Statistics showed that job growth continues in the US, with nonfarm payroll employment up 248,000 in September and 1.9% versus a year ago. Nonfarm payroll growth has been advancing between 1.5-2.0% year-over-year for a remarkable 36 consecutive months **(see chart below)**—clearly a positive, but well-established, trend. In that regard, September's jobs report conveys little new information about the US economy.

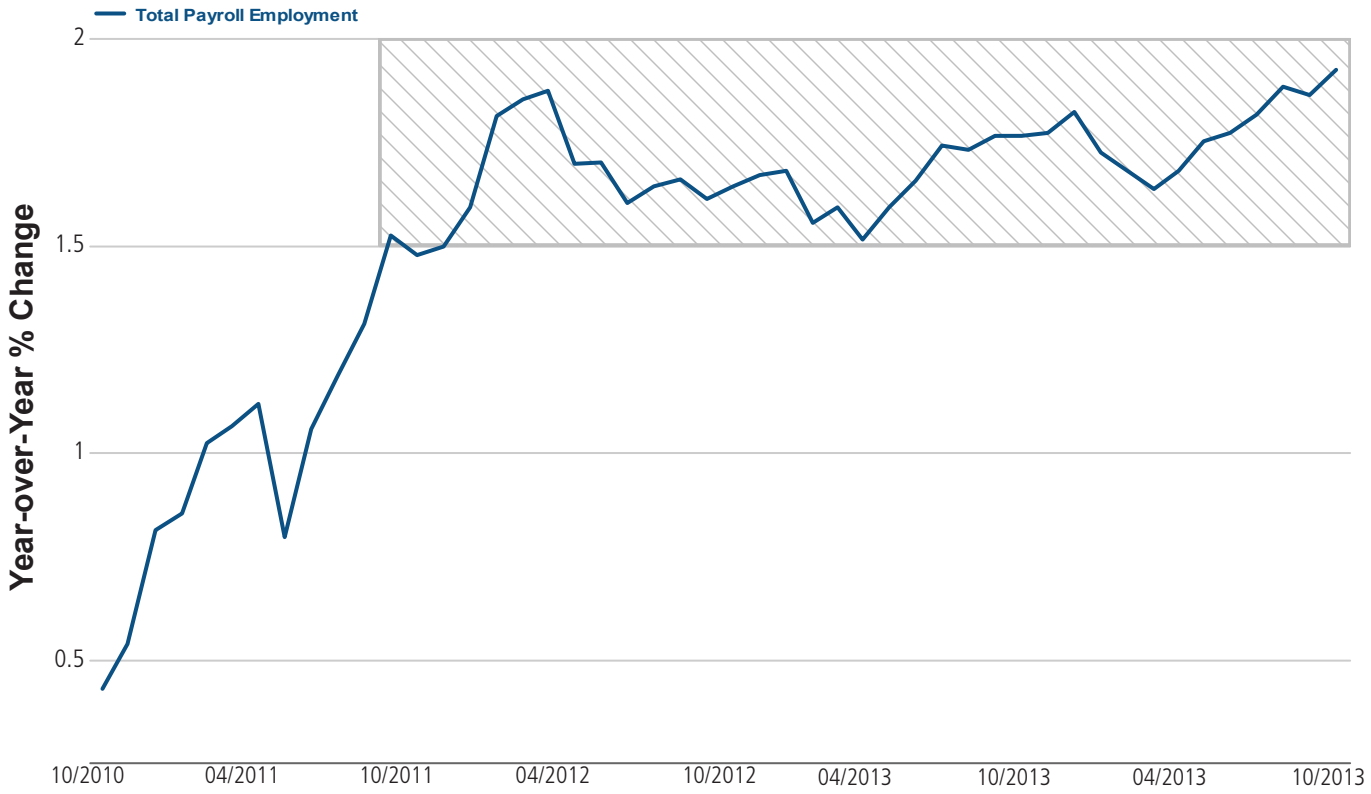
Far less clear is the answer to a long-standing macro question: how tight is the US labor market? As the unemployment rate falls below 6% (5.9% as of September) and heads closer to "full employment" (projected to be roughly 5.25%), shouldn't policymakers tighten monetary policy? If the labor market has tightened, then the answer is yes. If the labor market has yet to return to health and slack remains, the answer is no.

Our take on the labor market tightness question: the continued decline in the labor force participation rate (which fell to 62.7% in September and is down from 65.0% as recently as October 2009) suggests more than just a demographics-driven decline as the population ages. According to today's report, the number of people "out of the labor force but wanting a job now" remains distressingly high: 6.0 million versus 5.8 million a year ago. What's more, our best thinking is that that if tightness were really a problem, wages would be on the rise.

They aren't. Through September, overall wage growth is up just 2.2% compared to a year ago. The average annual wage gain for all private sector employees over the past 6 months was just 2% **(see chart on next page)**. In short, there's no sign that employers have to pay employees more to meet booming demand.

In fact, reflecting back to January, the market consensus foresaw a tightening in the labor market in 2014. The improvement, in turn, would cause wage growth acceleration that would finally spill over into overall inflation. Instead, overall inflation fell in August, with the

REMARKABLE: TREND EMPLOYMENT GROWTH STUCK BETWEEN 1.5-2.0% YEAR-OVER-YEAR FOR 36 CONSECUTIVE MONTHS DATING BACK TO THE FALL OF 2011



core personal consumption expenditures (PCE) price index up only 1.47% since last year. The Fed's favorite inflation gauge has now been below 2% for 68 of the 71 months since the Lehman collapse—a stretch of sub-2% readings we have not seen since the early 1960s.

For us, such persistently low inflation seals the argument: there is little reason for the Fed to rush to hike rates. For policymakers especially, uncertainty surrounding the wage/inflation issue is key. Put yourself in the shoes of FOMC members: why hike rates if there is at least some evidence that considerable slack remains *and* inflation is below target?

The lessons of history confirm a cautious approach. The Fed made the mistake of tightening policy prematurely in 1936-1937, and the US tumbled back into a recession. Japan's central bank pursued a similar course in the 1990s with well-advertised results. And, the ECB, implemented two notorious rate hikes (2008 and 2011), and today Mr. Draghi faces outright deflation risk across much of the euro area. The lesson, as best explained last week in a speech by the President of the Chicago Fed, Charlie Evans, is that central bankers ought to welcome a "modest overshooting of our inflation target" and that "although we've made great strides, a great degree of slack remains in the labor market". With inflation below target, "patience is a virtue when normalizing monetary policy."

With "Patience is a Virtue" as a mantra, it does not seem like the Fed is in any rush to hike rates despite today's welcome news on jobs.

WHETHER MEASURED BY AVERAGE HOURLY EARNINGS OR THE EMPLOYMENT COST INDEX (ECI), PAY INCREASES HAVE NOT SPED UP DRAMATICALLY.CONSECUTIVE MONTHS DATING BACK TO THE FALL OF 2011