Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 5, 2012

The Fed's Unemployment Rate "Problem"

"Unemployment is like a headache or a high temperature--unpleasant and exhausting but not carrying in itself any explanation of its cause." – William Henry Beveridge, British Economist, 1879-1963

At the September FOMC meeting, Federal Reserve policymakers explicitly tied bond purchase initiatives ("QEX") to a "substantial improvement" in labor market conditions. Some analysts have even speculated that the Fed may soon adopt the "Evans Rule." Named after Chicago Fed President Charles Evans, the rule stipulates that so long as core inflation remains below 3% the FOMC should maintain an accommodative stance until the unemployment rate falls below 7%.

With such suggestions circulating each month's labor market report commands uncommon scrutiny from financial market participants. In September, total nonfarm payroll employment rose by 114,000. Year-to-date, payroll growth averaged 146,000 per month, compared with an average monthly gain of 153,000 in 2011. Over the last three months, monthly payroll growth averaged +145,000.

But what really grabbed market attention was the unemployment rate. The unemployment rate dropped to 7.8% from 8.1%--its lowest reading since January 2009 and the diametric opposite of consensus expectations for a +0.1 increase to 8.2%.

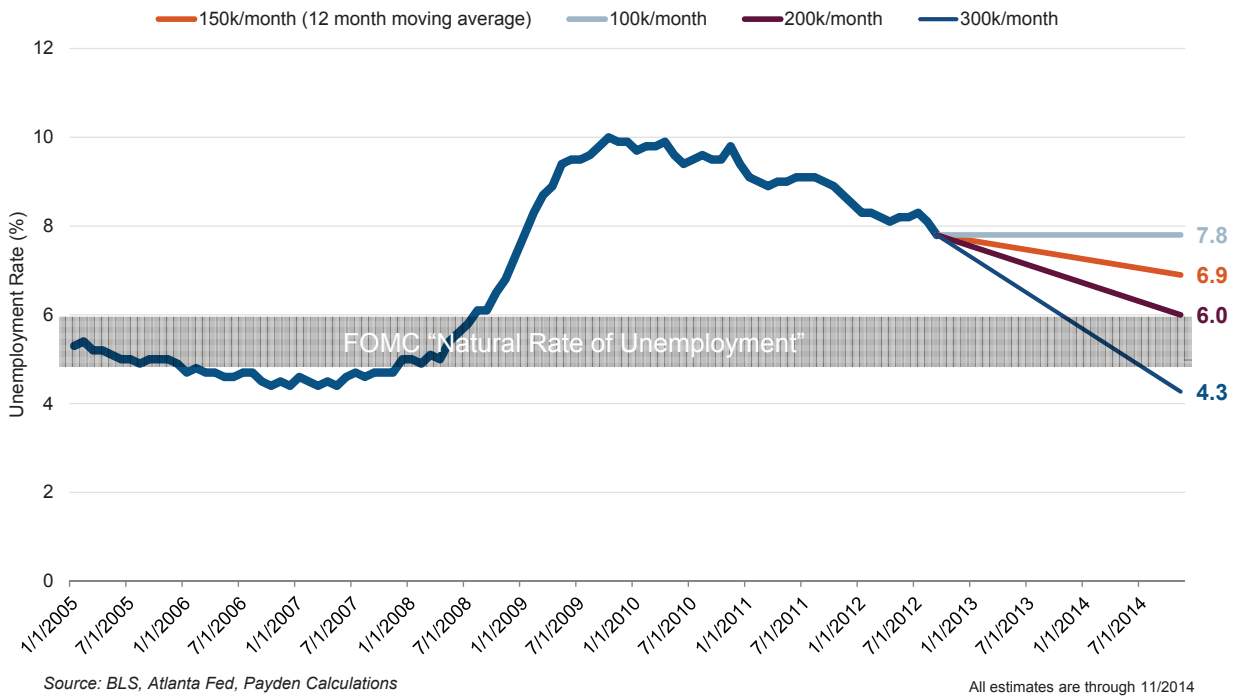
Despite the exuberance that the 0.3% drop elicited, underlying labor market trends remain little changed. It is important to remember that the unemployment rate is derived from the volatile household measure of employment (which was up +817,000 during September). Such a surge is rare: September's number was the largest one-month jump since 1983.

Further, many of these household workers are part-time workers "for economic reasons." In BLS-speak, this means they desire full-time employment but cannot find it. Workers working part time for economic reasons rose 582,000 during the month. As it stands, 8.6 million workers remain stuck in this part time for economic reasons category (***See Chart below***). Evidence of this kind points to an extremely weak labor market not a healthy one gaining traction. Additionally, the U-6 measure of the unemployment rate, which include employees working part-time for economic reasons as part of the unemployed unlike the BLS's U-3 measures, better captures the situation; it did not budge in September from 14.7%.

NOT A SIGN OF STRENGTH: PART-TIME WORKERS FOR ECONOMIC REASONS

Source: BLS

IN ORDER TO REACH FOMC RANGE FOR THE UNEMPLOYMENT RATE, THE US ECONOMY WILL HAVE TO ADD +200K JOBS/MONTH



All of this considered, here is the problem with the Fed's communication strategy: the unemployment rate should not be the true gauge of economic strength, at least on a basis that is timely for economic policymaking (e.g., month-to-month changes in the size of a bond buying program). It vacillates month to month based on a slew of moving parts (**For more on this topic, see our Point of View for Q2 2012 – Page 6**). Perhaps that's why at least some FOMC participants shied away from explicit targets in the September FOMC statement. Below we extracted a telling selection from the minutes of that meeting:

> "Many participants thought that more-effective forward guidance could be provided by specifying ***numerical thresholds for labor market and inflation indicators*** [the "Evans Rule"] that would be consistent with maintaining the federal funds rate at exceptionally low levels. However, reaching agreement on specific thresholds could be challenging given the diversity of participants' views, and ***some were reluctant to specify explicit numerical thresholds out of concern that such thresholds would necessarily be too simple to fully capture the complexities of the economy*** and the policy process or could be incorrectly interpreted as triggers prompting an automatic policy response." [Emphasis ours]

This month's unexpected unemployment report demonstrated precisely the "complexities of the economy." While some measures of economic health improve month to month, others do not—and the relationship between two variables (or more) is not always uniform. Today's employment situation report provides a lesson to the Fed on the problems with targeting the unemployment rate.

Bottom line: even from the new starting point of 7.8%, it will take ~200,000 jobs per month, each and every month (using the payroll survey numbers) to get into the Fed's "target range" before the end of 2014 (***See Chart Above***): possible, but unlikely in our view. Payroll growth remains anemic and the volatile household number suggests some "payback" is likely in coming months.