Monitoring the Dual Mandate of the Federal Reserve

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Along with its original task of maintaining the safety, integrity, and security of the US banking system, in the post WWII period the Federal Reserve (Fed) has also been charged with encouraging full employment and maintaining price stability. The Fed currently interprets its employment mandate with the economic measure of an unemployment rate of less than 6.5%. For its price stability mandate, the Fed focuses on the personal consumption expenditure price index less food and energy. Given the Fed’s worries that the economy not slip into a deflationary situation, the current objective is to see the economy’s inflation rate rise above the long-term target of 2% and be above 2.5% to provide clear evidence that deflationary pressures have been averted.

The Fed’s next two big policy decisions are when to taper off or end asset purchases (i.e., quantitative easing) and when to commence raising its federal funds target rate. The QE exit decision is likely to be determined by the path of the unemployment rate, and the federal funds rate decision is likely to be determined by the path of the inflation rate, although the progress in reducing the unemployment rate is critical, too.

This research report monitors the progress the economy is making relative to the unemployment rate and the inflation decision criteria of the Fed. To anticipate our key conclusions:

- Federal funds rate futures signal short-term rates may start rising sooner than current Fed/FOMC guidance suggests
- Congressional oversight of the Fed to intensify, and Senate confirmation hearings for the next Fed Chair may be especially contentious and add to bond market volatility

**Unemployment Rate may drop to 6.5% during the April-August 2014 period**

The current unemployment rate is 7.6% (data for June 2013, released on 5 July 2013), which is 1.1% above the Fed’s unemployment rate criteria. The directional trend toward a 6.5% unemployment rate, however, seems firmly established. Recent labor market trends (Figure 1), if continued, suggest that the unemployment rate could hit 6.5% in August of 2014, while our more optimistic scenario of the US economy suggests that April 2014 is possible.

This research report monitors the progress the economy is making relative to the unemployment rate and the inflation decision criteria of the Fed. To anticipate our key conclusions:

- Unemployment Rate may drop to 6.5% during the April-August 2014 period
- End of QE not likely to impede economic expansion
- Bond market volatility here to stay
- Inflation subdued now, risks rise during 2014, 2.5% rate passed in 2015
Interestingly, the largest risk to the projection that the unemployment rate might decline to 6.5% somewhere in the April-August 2014 period is not that the economy experiences a deceleration of economic growth, but that the growth rate of the labor force accelerates a little bit. According to the household survey conducted by the Bureau of Labor Statistics, the civilian labor force has grown at a pace of only 0.44% over the last twelve months. Since the size of the labor force constitutes the denominator of the unemployment rate calculation, should the labor force grow faster, then we would also need to see more rapid employment growth to bring down the unemployment rate.

There are both secular and cyclical considerations to understanding labor force growth. The long-term trend of US population growth is slowing, and with it, the long-term trend of labor force growth is also decelerating. Back in the 1970s, as baby boomers were entering the workforce, labor force growth was above 3% per year. Our analysis is that long-term labor force growth is on path toward near zero to be reached sometime in the next decade (Figure 2.).

From a cyclical perspective, the general expectation is that recessions push the marginal worker to leave the labor force (i.e., stop seeking employment), and that economic expansions draw marginal workers into the labor force. Our perspective is that the last economic expansion before the financial crash of 2008 was pushed to unsustainable growth by a housing boom fueled by excessively accommodative Federal Reserve policies – that is, keeping the target federal funds rate at a 1% level long after such a low rate could be reasonably justified. Thus, we believe many more marginal workers entered the labor force and found employment in 2003-2007 than would have been the case with a more balanced economy. Our conclusion is that many of the ultra-marginal workers, pushed out of the labor force in the recent deep recession, will choose never to return to the labor force during this economic expansion. Thus, the acceleration of labor force growth in this expansion cycle may be quite muted. This is not a consensus view and the central tendency of unemployment rate projections by Federal Open Market Committee (FOMC) members generally sees a slower decline in the unemployment rate in part because of assumptions about a faster growth rate of the labor force.

The secondary risk to the projection of when the unemployment rate will decline to 6.5% is the possibility that a weaker economy may not create net new jobs at a sufficient pace. There are certainly some important headwinds to economic growth, including the continuing recession in Europe and the delayed impact of the modest tax hikes and sequestration government expenditure cuts coming into play in 2013. On the positive side of the economic growth balance sheet are the natural robustness of the US economy to adapt to shocks, the expectation of a near-zero federal funds rate well into the future regardless of the quantitative easing decision, and the energy growth dividend currently being fed by the vast expansion of domestic oil and natural gas production. Our own perspective is that the most likely scenario is one in which the US economy returns to +3% real GDP growth in 2014.

What is not on our list as a major risk factor, although many consider it a serious risk, is that the end of quantitative easing will disrupt the progress of the economy, especially the housing market. We have never been in the camp that thought QE 2-3-4 did much of anything to encourage job creation; instead working mainly to lower long-term bond yields from what they would have otherwise been while removing volatility from the US Treasury market. Given our view that QE 2-3-4 was mostly a Treasury bond market event, we are reasonably comfortable that a permanent return to more normal levels of bond market volatility (Figure 3.) and a more economically justified premium of the Treasury bond yield over current inflation will not cause problems for the US economy.

In the housing market, credit standards increased so sharply after the 2008 financial crisis that even Fannie Mae and Freddie Mac shifted to a focus on only the highest quality borrowers. This group will be little affected by higher bond yields which are pushing up fixed-interest mortgage costs, as they can still obtain low-rate floating rate financing. Moreover, the rebound in housing is being driven in no small part by increased household formation, which was put on hold for a few years by the recession but has been
coming back strong in 2012 and 2013. Indeed, some real estate agents report that speculation about higher fixed-term mortgage rates associated with the end of QE debate have actually motivated some house buyers to come into the market before fixed-rate mortgages rise further.

Our conclusion, in line with signals from Fed officials, is that the end of QE is near, so long as the unemployment rate appears on a path toward 6.5% in 2014, and we think that is a highly probable scenario. As one might expect, even a debate about when the end of QE might occur has been accompanied by sharp increase in Treasury bond market volatility, back to more normal levels, and a rise in US Treasury yields. While the market activity surrounding the QE exit debate was in May and June, it is useful to take a slightly longer view of how prices and yields have shifted. Since the end of 2012, the yield on the 10-year US Treasury Note went from 1.8% to 2.5% at end June, and then higher after the employment data released on the 5th of July. In equity markets, the S&P500 Index rose 12.6% in the first half of 2012 and notably even rallied on the 5th of July when bonds were selling-off sharply after the employment data release.

Inflation subdued now, risks rise in 2014 and beyond

The Fed’s decision on when to commence raising its federal funds rate target is likely to be constrained by latent Fed worries about avoiding deflation and a desire to keep monetary policy decidedly accommodative during and immediately after the QE exit period. This puts the inflation rate into the limelight as the economic indicator that may have the most impact on the timing of the Fed’s rate decision. Currently, no matter what measure of prices one chooses, inflation is subdued. The current (May 2013 data) year-over-year percentage price increase ranges from 1.02% (personal consumption expenditure price index) to 1.68% (core consumer price index), with the general consumer price index and core personal consumption price index falling in between. If recent trends continue indefinitely, the inflation rate would not rise above 2.5%.

We do not believe that inflation is permanently subdued. Indeed, we are of the view that the most likely scenario is for rising inflation commencing in 2014 and accelerating in 2015. There are two main reasons why inflation is subdued even after four years of monetary accommodation. First, due to the depth of the financially-induced recession, the economy was not interest-rate sensitive during the three to four years after the crisis while deleveraging was in process. This meant the zero-rate policy did not provide the usual stimulus for the economy. Second, the simultaneous adoption of quantitative easing policies by major central banks around the world prevented any exchange rate feedback effects to inflation that might have occurred if the US were acting in isolation, which it most definitely was not. Our current research into the velocity of money and our interpretation of inflation theories suggest that both core and general price indices will start rising in 2014 but will not see 2.5% inflation until 2015 (Figure 4.). Many FOMC members put that date into 2016 or beyond.

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Figure 3

**US Treasury 10-Year Note Volatility**

Figures show the volatility of US Treasury 10-Year Notes from 2008 to 2014. The chart highlights the impact of various events such as the European Debt Crisis, QE 3/4 Depresses Volatility, and QE’s end in 2013.

Figure 4

**US Core Inflation, Less Food & Energy**

This chart illustrates the year-over-year percentage change in US core inflation, less food & energy, from 1991 to 2016. It shows the trend of inflation over time, with a particular focus on foods, energy, and core inflation.

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The federal funds rate futures market operated by CME has shifted its implied interpretation of when the Fed might raise rates quite sharply in recent months. As recently as 30 April 2013, the maturity curve of federal funds rate futures prices, which goes out 36 months, suggested April 2016 as the first month when the effective federal funds rate would average 50 basis points or higher. After the employment data released on 5 July 2013, that same maturity curve was suggesting that the effective federal funds rate could average 25 basis points or higher by April 2014, and 50 basis points or higher by March 2015. If this market interpretation of the implied federal funds rate comes to pass, it would mean that the Fed would make its decision to start raising its target federal funds rate as much as one year ahead of what most FOMC members currently are implying in their public pronouncements (Figure 5).

**Market Volatility to Continue as Fed Becomes More Entwined in the Political Process**

Our most confident projection is that bond and rate markets will be highly volatile as they assess the prospects for a change in Fed policy. The Fed is always careful to put a long list of caveats behind any guidance it chooses to provide, arguing that QE tapering off may be uneven and hard to project. Moreover, there is the possibility that the US Congress may decide to take an interest in the unrealized losses the Fed is incurring from rising Treasury bond yields. These unrealized losses have the potential to swamp the capital account of the Fed, although we should note that central banks can print money and easily conduct monetary policy operations whether they are technically solvent or not. And then, Chairman Bernanke appears to be planning to leave Fed when his term as Chair expires at the end of January 2014. The QE exit decision is more than likely the last big Fed decision to be guided by Chairman Bernanke. The next Fed Chair will be at the helm when the rate decision is made, and the this person will also have to face the US Congress and explain the potential unintended consequences of quantitative easing, including the possibility of hundreds of billions of unrealized losses on Fed-owned US Treasuries and mortgage-backed securities.

Indeed, the Senate confirmation hearing for whomever President Obama nominates as the next Fed Chair are quite likely to be a major spectacle. A lot is at stake. Fed Chairmen typically survive changes of Presidential administrations. Paul Volcker, Alan Greenspan, and Ben Bernanke were all appointed by a President of one party and then re-appointed by a President from the other party. Taking on the mantle of Fed chair gives one an incredible air of legitimacy and indispensability. The confirmation hearings for the next Fed chair are likely to draw the Fed more into the political limelight and have the potential of weakening the institution’s policy independence. All of this is a recipe for more bond and rate market volatility than experienced during the periods of quantitative easing over the last two years.

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