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ECONOMIC TALKING POINTS

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Federal Reserve to Lift Rates Sooner Than Expected, But Not to Worry!

We have been advising clients the last two weeks that the Federal Reserve will act sooner to raise the fed funds rate.

Conventional thinking has the Fed lifting the benchmark rate for the first time in nearly a decade sometime in the second half of 2015. However our assessment of current and future economic trends point to the first hike coming in the March 17 – 18th FOMC meeting, or certainly no later than the June 16 -17th session.

We expect the Fed will begin to set the stage next week by signaling that its zero-bound interest rate policy will soon be history. The most likely clue will come from the FOMC statement when it scraps the phrase that rates will be held near zero "for a considerable time after the asset purchase program ends."

If they do jettison that text, two questions immediately surface. First, why make that change now when recent data on employment and retail sales were so weak? And second, how will the economy react if the Fed gears up to tighten?

Let's address the first question. There is now mounting evidence that both August's soft payroll numbers and July's weak consumer spending were aberrations and do not accurately reflect the economy's underlying strength. We know last week's disappointing employment numbers conspicuously diverged from virtually every other preceding report on labor market conditions.

This week, we received additional data points showing a more robust job market.

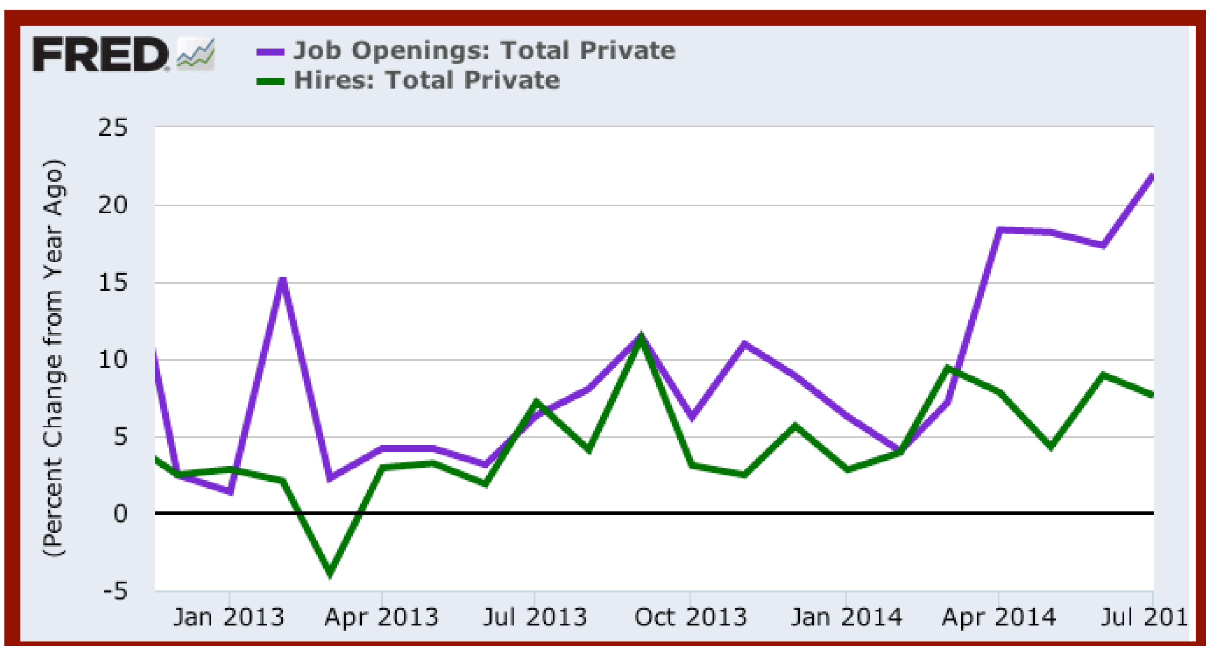
Let's start with the release of the optimism survey put out by the *National Federation of Independent Business (NFIB),* a trade group representing the views of small and mid-size businesses. They typically hire 7 out of 10 new workers in the economy. The group's optimism of future business activity during August was the second highest since October 2007. This upbeat view led them to accelerate the pace of hiring to the fastest of the year. The NFIB also noted in its release that more members plan to ramp up capital expenditures the next 3 to 6 months than at anytime since November 2007! A jump in business investments generally leads to more hiring.

But let's not stop here. Check out the latest stats in the *Job Openings and Labor Turnover* survey (JOLT). This release is closely studied by the Yellen Fed because it provides additional details on labor market conditions. Here are some of its highlights:

- The number of job vacancies in the private sector surged to 4.19 million positions in July, the most in 7 years.
- What is especially noteworthy is that the number of job openings has now climbed for six straight months, **the longest stretch in the history of this series** (which the BLS started in 2000).

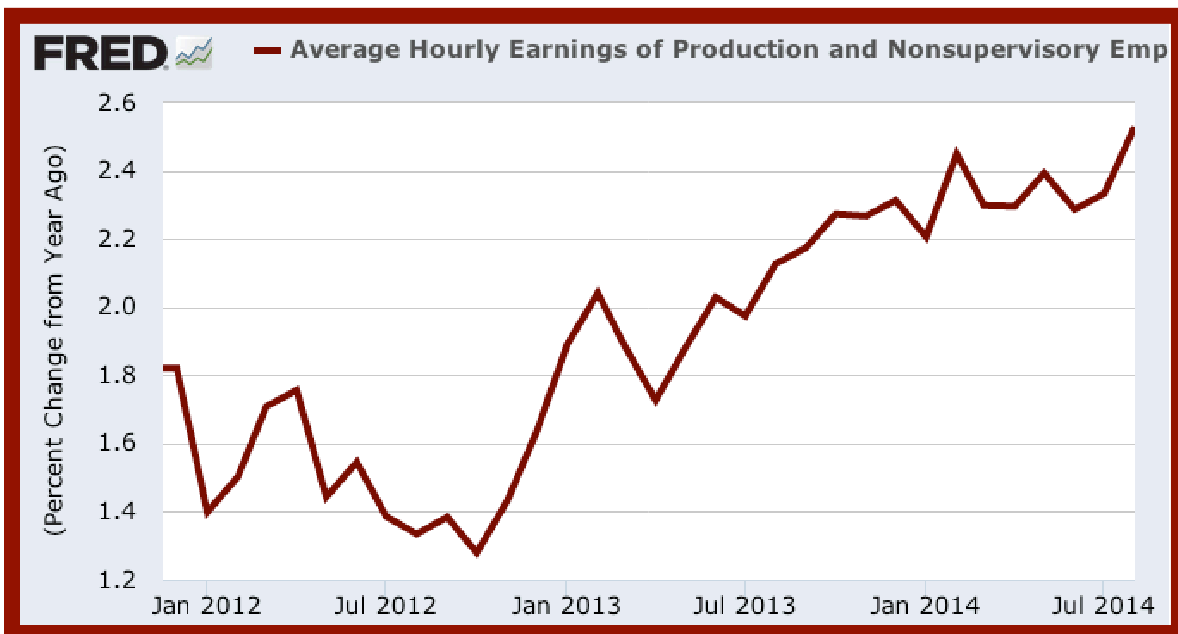
- The problem is many firms are having difficulty filling these posts. **While the number of job openings surged 22% over the last 12 months, hiring increased only 7.6% the same period.**

% Change year-over-year, Job Openings vs. Job Hires, in private sector



The competition employers now face to find qualified, or at least trainable people, has already put upward pressure on wages. **Average hourly earnings for production and nonsupervisory workers in the private sector (a measure that is most sensitive to turning points in the job cycle) rose 2.5% last month from its year ago level. This is the biggest annual increase since May 2010. That must have caught the attention of several members on the FOMC.**

% Change year-over-year, average hourly earnings: August 2.5%



- By the way, another favorite measure for Yellen is the quit rate. As confidence in the economy and job opportunities builds, more people will voluntarily choose to leave their current position for another, more lucrative post. That trend is now underway, according to the JOLT report. **Some 2.38 million people in the private sector left their jobs to seek out better opportunities, the highest number in six years.** Indeed, the proportion of quits from all separations (which also includes layoffs, discharges, those retiring and on disability) has been rising steadily this year. The quit level in July accounted for 55.5% of all separations. That compares with 53.8% a year ago and a low 42.9% when the recession bottomed out in June 2009.

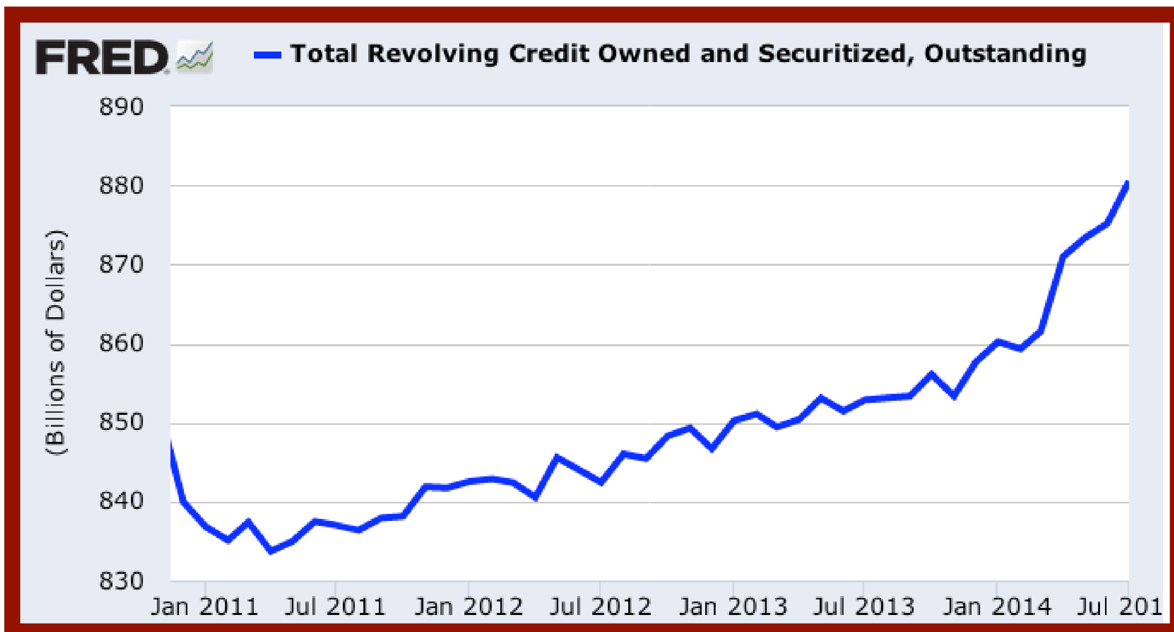
As I have said before, we could well be at a critical inflection point in the labor market where the balance of power is gradually shifting from employers to employees. One manifestation of this will be additional signs of faster wage growth in the coming months. This is precisely what Fed policymakers are waiting to see before moving ahead with monetary tightening.

Let’s now look at consumer spending patterns. While the July’s *retail sales* total was initially flat, we expect it to be revised up on Friday, with an even healthier increase for August. Why be so dismissive of the last retail sales numbers? Because other gauges of consumer expenditures indicate more robust shopping.

- *Consumer credit* in July shot up by $26 billion in July, the most for a single month in 13 years! (By the way, June was revised up to also show a hefty $18.8 billion increase). July’s nonrevolving debt jumped $20.6 billion as Americans spent more on autos and college tuition.

We prefer to track revolving debt and here credit card lending rose $5.4 billion, in July, to $880.5 billion. **This is the fifth consecutive monthly increase in revolving loans, the longest stretch in 6 years!**

Revolving debt at $880.5 billion is most in more than 4 years!



- Another favorite measure of ours is the *Gallup survey of average daily spending by consumers*, and it rose to $94 a day in July, versus $91 in June.

- Retail sales likely rebound markedly in August, in part because we know Americans were comfortable enough to buy motor vehicles at a 17.5 million unit annual pace, the most since January 2006.

- Home purchases also climbed significantly in July and this typically leads to greater spending on appliances and furnishings. *Existing home sales*, which represents about 90% of the residential market, climbed to a 10-month high in July. Research shows that with the each existing home bought, the buyers tend to purchase at least two new major appliances.

- Finally, our expectation of faster wage growth and stronger job numbers in the coming months should further embolden consumers to ramp up shopping.

Will a tighter monetary policy hurt consumer and business spending next year?

The prospect of higher short-term rates next year will raise fresh concerns about the economy outlook and may temporarily jar financial markets.

But we do not believe it will have a material impact on growth for the simple reason that the real fed funds rate will remain negative, and thus stimulative well into 2016. For example, even if the Fed were to raise rates by 25 basis points at each meeting beginning next March (we chose 25 basis point increments because Yellen has repeatedly said the lift off will be very shallow and gradual), we'll end 2015 with the benchmark borrowing rate at about 1.5%. (By the way, this is even higher than the Fed's own June projection of 1.13% at the end of next year.)

Inflation, which is currently running at between 1.5% to 2% a year, depending on the measure used, will almost certainly creep higher next year as the slack in both the labor market and industrial capacity diminishes. In fact, we do not think the fed funds rate will even approach its equilibrium level of a 2% positive real rate (where it is neither stimulative nor tight) until 2017 at the earliest!

What all this suggests is that in the absence of a disruptive geopolitical shock (not an insignificant caveat by the way), this expansion has a chance of becoming the longest in US history.

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