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ECONOMIC TALKING POINTS

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Ending the Year With Some Economic Fireworks

The year's last employment report left little ambiguity about labor market conditions. The rebound in hiring, hours worked, overtime, and wages all reflect an economy that is ready to enter 2015 with lots of momentum. This uninterrupted improvement in the job sector throughout the year, along with a spate of other upbeat economic news, adds more pressure on the Federal Reserve to raise short-term rates even sooner than the mid-year time frame often hinted in Fed comments.

Chart 1. Unemployment rate, seasonally adjusted, November 2012 – November 2014

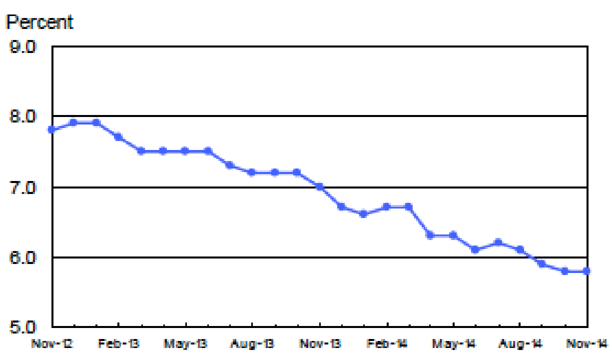
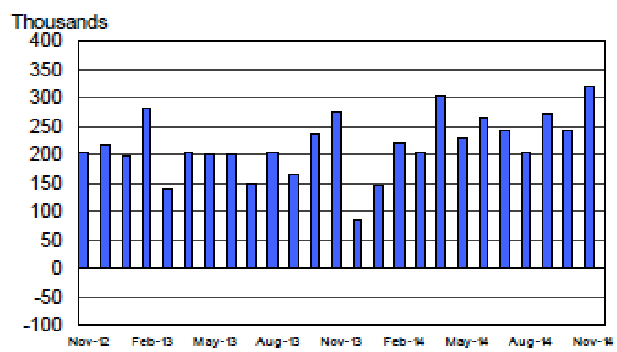


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, November 2012 – November 2014



The argument to advance the date of tightening is only getting stronger. First of all, the threat of deflation in the US is non-existent when it is due solely to external factors, like plunging oil prices and weak foreign economic activity. Neither deflation or disinflation can really take hold when domestic consumer and business activity is as robust as it now is. In other words, Fed policymakers have to make the distinction between disinflation pressures that occur because the US economy is profoundly weak with demand plummeting (clearly, not the case now!)--- and when it is largely the result of lower energy prices, a strong dollar and recessionary conditions *outside* this country.

Given the string of healthy US economic reports all year (ISM manufacturing and services, Beige Book, GDP, job vacancies, confidence levels, and applications for unemployment benefits), the bigger risk at this juncture is if short-term rates remain near zero beyond the summer. That's because banks may now view the economy's expansion as more durable and feel more comfortable tapping their idle reserves to satisfy the surge in demand for loans. The danger is credit creation can explode quite rapidly, or at least grow at a pace faster than the Fed ever anticipated.

That's why the Fed's December 16-17 meeting takes on more importance. We believe policymakers will take two important steps at this gathering.

First, the long entrenched phrase in the FOMC statement that short term rates will remain near zero for a "considerable time" will be chucked. Not to do so would increase the perception that the Federal Reserve is in danger of acting too slowly and eventually end up falling behind the inflation curve.

Second, we expect to see more substantive textual changes in the statement that would convey its zero-bound interest rate policy could come to an end sooner, though the exact date for its termination would still depend on upcoming economic data.

Yes, there will likely be some resistance to these changes. Private economists have argued the US economy cannot possibly sustain its current momentum in the face of such weakness abroad, and that this widespread stagnation will soon ricochet and hurt our own economy. We do not agree. All the data we have seen tell us the US is well positioned for growth to continue several more years.

Indeed, November's employment report only underscores how little effect the poor performance overseas is having on the US.

• Total US job creation in 2014 is wrapping up to be the fastest in more than 15 years, ***with the pace actually accelerating in recent months!!***

Indeed, if history is any guide, the 321,000 increase in November payrolls will likely be revised higher next month. (The BLS undercounted the initial payroll numbers in each of the last six months.)

• Moreover, the proportion of Americans (employment/population ratio) now working matched October's level of 59.2%, the most in five years.

• The number of people stuck in part time jobs for economic reasons fell again last month, to 6.85 million, lowest in six years.

• The overall improvement in labor market conditions also lifted wages. Average weekly earnings was up 2.4% the past 12 months, the biggest leap this year. That upward trend, plus the plunge in gas prices, provide households with the financial firepower to keep on spending in 2015.

Clearly, the domestic economy has decoupled from the rest of the world as pent up demand by American consumers and businesses brings on greater spending and investments the next two years. After that, once domestic demand eases back, US companies should benefit once again as foreign economies emerge from their protracted slump and increase their imports from this country.

And so we return to our original concern about the timing of monetary policy the next 12 months. If job creation continues its current path into 2015,we expect to see the unemployment rate drop to 4.8% by the end of next year. If it is on this glide path and slips under 5%, it would be utterly reckless for the Fed to have its benchmark short term rate remain *below* inflation. The Fed should gently tap the monetary brakes no later than next spring and bring an end to the days of a negative real fed funds rate twelve months from now.

Key Economic Forecasts

- Actual
- Forecast

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United States

	I 2013	II 2013	III 2013	IV 2013	I 2014	II 2014	III 2014	IV 2014	I 2015	II 2015	III 2015	IV 2015
Real Gross Domestic Product (GDP):												
%	2.7	1.8	4.5	3.5	-2.1	4.6	3.9	3.5	2.9	3.5	3.4	3.3
Personal Consumption Expenditures:												
PCE	3.6	1.8	2.0	3.7	1.2	2.5	2.2	3.0	4.0	3.4	2.8	3.1
Inflation, end of period, year-over-year:												
CPI %	1.5	1.8	1.2	1.5	1.5	2.1	1.7	1.8	2.0	2.3	2.5	2.6
Unemployment Rate (end of period):												
%	7.6	7.6	7.2	6.7	6.7	6.1	5.9	5.8	5.5	5.3	5.1	4.8
Non-farm Payrolls, monthly avg. thousand:												
	206	201	172	198	189	267	240	275	250	265	250	250
Treasury 10-yr Note Yield % (end of period)												
	1.9	2.5	2.6	3.0	2.7	2.5	2.5	2.5	2.8	2.9	3.2	3.5
Federal funds rate % (end of period)												
	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.25	1.75

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
US	1.8	-0.3	-2.8	2.5	1.6	2.3	2.2	2.5	3.1	3.3
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.4	1.1	1.7
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	3.0	2.6	2.9
Japan	2.1	-0.7	-5.4	4.6	-0.7	1.6	1.5	1.2	1.0	1.7
Canada	2.7	0.7	-2.8	3.2	2.5	1.7	2.0	2.3	2.7	2.9
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	5.5	6.5	7.0
China	14.2	9.6	9.2	10.5	9.3	7.8	7.7	7.1	6.9	6.7
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.3	1.2	2.2
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.1	2.4	3.5	4.1
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.6	2.7	3.0
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	-1.5	-0.6	1.0
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	2.9	3.2	3.6

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