THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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A Done Deal? October's Strong Employment Report Moves the Fed Much Closer to a Rate Hike in December

For two months we have been telling clients to disregard the disappointing summer jobs data. We needed to get past those seasonally messy employment numbers to see a clearer picture on the health of the job market and economy.

Now we got our first look and the results are unambiguous. The 271,000 jump in payrolls last month along with the 2.5% annual increase in average hourly earnings means the decade long stretch of near zero interest rates will become history next month. You cannot possibly justify having an emergency fed funds rate any longer with unemployment now at 5%. The fundamentals of the economy --- from consumer and business spending to employment --- look sufficiently robust. It's now time for the Fed to move on.

In many ways, the October employment report is the antithesis of September's disappointing stats. The pace of hiring last month (271K) was the fastest so far this year. The jobless rate at 5% is now the lowest in more than seven years. The broader unemployment measure (U-6), fell to 9.8%, the smallest since May of 2008. Americans stuck with part time employment because they couldn't find suitable full time work fell to 5.77 million, down 1.2 million from a year ago, and is the smallest figure since June 2008.

Chart 1. Unemployment rate, seasonally adjusted, October 2013 – October 2015

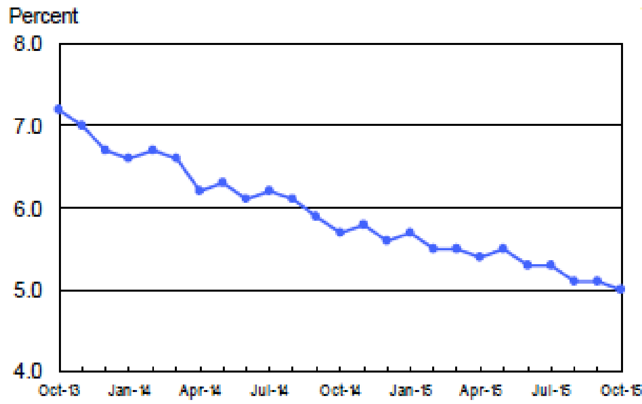
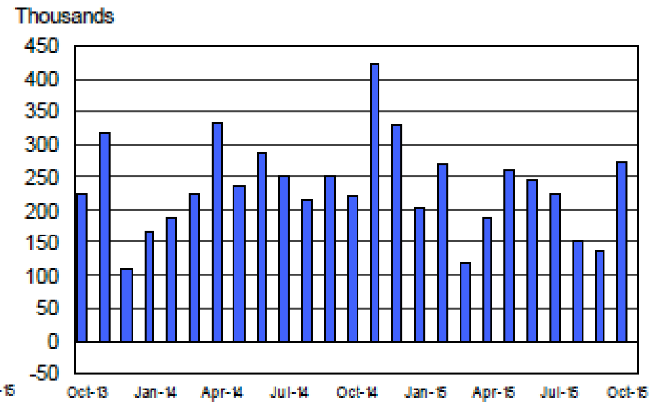


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, October 2013 – October 2015



As for wage growth, average hourly earnings were up 2.5% over the last 12 months. Sure, we would like to see an even bigger increase. But with inflation still hovering close to zero, Americans are nevertheless enjoying real purchasing power. Moreover, we expect the gap between pay and inflation to widen further in the coming year, as firms bid up the price for increasingly scarce labor (…remember the JOLTs survey shows employers are trying to fill a near record number of positions). At the same, forces driving inflation are expected to remain mute. We see no spike in energy prices or interest rates in 2016. And given the inclination of the Fed to raise rates when virtually all other major central banks are easing suggests the dollar will stay strong enough to keep import prices from escalating.

By the way, one of our favorite subsets in the jobs report is the number of hires at day care centers. Many states require such places to have a specific ratio of caregivers to children they monitor. The more children brought in, the more adults the day care needs to hire. Typically, a rise in day care employment indicates that more parents are finding jobs and have made arrangements to leave their young children at these locations. October's report showed day care centers last month hired 2,700 additional people to bring total employment in this sector to a record high 877,300.

Another data point worth monitoring in the months ahead will be manufacturing overtime, which rose a tenth to 3.3 hours last month. Could manufacturers have let go so many employees that those remaining are now forced to work overtime just when the economy is re-accelerating? Manufacturing employment has fallen by 28,000 since July, to 12.32 million in October. If the overtime persists, it could foreshadow a jobs recovery in manufacturing later this year and in 2016.

How will October's strong employment numbers influence thinking at the Federal Reserve?

At the very least, one can say there is no ambiguity about current labor market conditions. This was a strong report and one that possessed more credibility than the disappointing, noise-filled summer job stats. While there are numerous other barometers of the economy scheduled to be released between now and the December 15-16 FOMC meeting, including one more employment release, we believe that in the absence of a geopolitical or economic shock, the long drum roll signaling a rate increase will come to an end next month. This economy can easily handle it. The financial markets are already discounting such a move. The international community, especially many emerging countries, has pleaded with the Fed to end the seemingly perennial uncertainty over US interest rate policy. Simply put, it's time to proceed with a quarter point rate increase!

Finally, though the Fed will never admit to this, we suspect policymakers there cannot ignore the quiet whispers in its own corridors that perhaps now is the best time to act for …dare we say it… political reasons. Not to act now means a possible rate increase sometime in 2016. But do they really want to begin the first interest rate tightening cycle in ten years right in the middle of a heated presidential campaign? Probably not. That would put the central bank too much in the spotlight at the worst possible time. We expect the Fed will choose to lift rates 25 basis points at the December meeting--- and then keep a low profile for much of next year.

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