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TRENDMACRO LIVE!

On the May Jobs Report

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Slowing job losses don't mean the Fed will get on the job of inflation fighting.

Update to strategic view
US MACRO, FED FUNDS: A better than expected payroll jobs report proves that the recession is in the process of bottoming out. But that doesn't necessarily imply a return to robust growth, and isn't likely to move the Fed to tighten policy anytime soon.
[see Investment Strategy Dashboard]

This morning's surprisingly upbeat report that payroll job losses last month were held to 345,000 -- about half the average level of the past six months and a good deal better than the half million-plus that was expected -- is consistent with a string of data indicating that the economy is emerging from recession (see "Green Overshoots" May 29, 2009). Earlier this week the ISM manufacturing survey, one of the more accurate coincident indicators, showed new orders above breakeven levels for the first time since December 2007, which has been marked as the official peak of the last business cycle. The peak in initial jobless claims, which has historically been a reliable indicator of the timing of official recession troughs, appears to have come in early April. And manufacturers' new orders for nondefense capital goods excluding aircraft have turned positive on a three-month annualized basis for the first time since last July, after falling by 34% through April.

The immediate market response to the news, with gold falling by more than $20 and the yield curve flattening by nearly 15 bp -- driven by a surprising leap in the 2-year Treasury yield -- would seem to cut against the inflation trend we've seen as likely to be sustained. But we don't see this, in and of itself, as a game-changer. The inference, confirmed by the biggest jump in months in fed funds futures on the probability of a Fed rate hike, is that the improving data will move the Fed soon toward beginning a reversal of its hyper-accommodative policy posture. That may also explain the luke-warm reaction of the stock market to this morning's data, retreating after staging an abortive attempt to break out from the downtrend line that has defined this bear market. But we think it's probably premature to assume that the Fed will snatch its policy crutches away from the economy anytime soon, and expect it to walk on its own. For one thing, a less grim employment report is not the same thing as a good employment report. We remain in the world of "second derivatives" -- the slowing of the negative rate of change -- not a world of "first derivatives," in which the direction of change itself points upward. To be sure, you have to go through the former in order to get to the latter, and indeed we think that's what's in the process of happening. But more likely than not, the Fed will want to see evidence of actual job growth before it begins to seriously consider a policy shift.

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Beyond that, the Fed's policy framework, as elucidated again by Fed chairman Ben Bernanke in congressional testimony this week, must be taken into account (see "They Laughed When I Sat Down to Monetize" June 4, 2009). "Even after a recovery gets under way," Bernanke told the House Budget Committee, "the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further." In the Fed's flawed output gap model, the "slack" in resource utilization means that the risk of rising inflation is a non-factor. Or, as Bernanke put it, "In this environment, we anticipate that inflation will remain low. The slack in resource utilization remains sizable, and, notwithstanding recent increases in the prices of oil and other commodities, cost pressures generally remain subdued."

For now, it's very likely that the Fed sees no compelling reason to consider any near-term policy change. As we noted earlier this week, an official at the San Francisco Fed recently wrote that policy should be kept in its current stance "not just for the next six or nine months but for several years" (see "Thrown A Curve" June 1, 2009). We doubt that he was expressing a view considered outside the consensus. The one thing that could change that would be the unmistakable appearance of a significant trend toward rising inflation. In fact, despite Bernanke's assurances, reported inflation has begun to shift higher. On a three-month annualized basis, the core PCE deflator -- which supposedly is the Fed's key statistical inflation indicator -- is rising at a 2.7% annual rate, having bottomed at 0.3% last December. That's still below a level that the Fed would consider truly worrisome, though it is well above its informal target. If it continues, and we believe it will, at some point the Fed will have no choice but to acknowledge the obvious, setting the stage for what is likely to be a lengthy and painful process of policy reversal. But that's still many months off. Moreover, it's important to bear in mind that even as this shift is in play, by any objective standard the Fed will remain easy for a long time to come, continuing to further embed inflation impulses into the system.

BOTTOM LINE: A better than expected payroll jobs report proves that the recession is in the process of bottoming out. But that doesn't necessarily imply a return to robust growth, and isn't likely to move the Fed to tighten policy anytime soon.