Weekly Economic Commentary

March 24, 2014

What's the Yellen Surprise?

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Highlights

The Fed's target for the fed funds rate in the long term is lower than in prior rate hike cycles.

The market has already priced in Fed rate hikes beginning in mid-2015.

Sustained growth in real gross domestic product (GDP) above 3.0% at any time over the next three years could elicit an earlier start to rate hikes by the Fed and/or more rate hikes once they commence.

The Fed's communication with investors and the public remains muddled, at best.

Last Wednesday, March 19, 2014, Janet Yellen conducted her first post-Federal Open Market Committee (FOMC) press conference as chair of the Federal Reserve (Fed). During and after the meeting, market participants and the financial media focused on her comment that a "considerable period"—referring to the length of time after the Fed ended their bond-buying program before they would begin to raise interest rates—was about six months. However, our focus remains on the metrics Yellen and her colleagues on the FOMC will monitor as the economy nears the FOMC's long-term targets of 2.0% for inflation and a 5.4% unemployment rate, and what they might mean for the economy and the business cycle.

Implications of the Statement

For investors, the key outcomes from the FOMC statement, economic and interest rate projections, and press conference are:

- The long-term fed funds target is lower than in prior cycles (and the rate of increase once rate hikes start is slower). But as of late last week (March 17–21, 2014), these are changes that markets have generally already priced in.
- Sustained growth in real gross domestic product (GDP) above 3.0% at any time over the next three years would be well above what the FOMC is now forecasting, and could elicit an earlier start to rate hikes by the Fed and/or more rate hikes once they commence.
- The Fed's communication with investors and the public remains muddled, at best.

The FOMC's own forecast for the fed funds rate in the "longer run" is roughly 3.75–4.0%. Since the FOMC began using the fed funds rate as a policy tool in the early 1980s, the median fed funds rate has been 5.25%, well above what the FOMC now considers to be a "neutral" or "longer run" fed funds rate. In addition, the FOMC statement, the projections by FOMC members, and Yellen's comments during the press conference suggested that the FOMC would keep the fed funds rate below its "longer run" target (3.75–4.0%) even after the unemployment rate and inflation were "normalized" due to the sluggish nature of the recovery. This suggests to us that the current recovery—now approaching its five-year anniversary—still has a ways to go, and may not be put in jeopardy by swift (and premature)

1 New Fed Chair Yellen Mentioned Employment and the Labor Market 30% More Than Inflation at Her Recent Press Conference

Employment vs. Inflation

Employment	13	Inflation	58
Labor Market	20	Price	1
Unemployment	37	Prices	1
Underemployment	1	Wage	6
Jobs	9		
Slack	5		
Total	85	Total	66

Source: LPL Financial Research, Federal Reserve 03/24/14

Wages: A Big Driver of Inflation, but Still Running Way Below Normal

While there are many drivers of inflation, one of the most important drivers is wages. In general, although input prices for raw materials like energy or grains get a great deal of attention from the financial media, compensation of employees accounts for around two-thirds of business costs. In turn, whether or not businesses are having success making price increases stick (not the dollar or the deficit or the size of the Fed's balance sheet) is the real key to having a sustained uptick in inflation. As noted by Fed Chair Yellen in her Q&A with the press following the FOMC meeting, wages remain subdued:

> The final thing I've mentioned is wages and wage growth has really been very low. I know there is perhaps one isolated measure of wage growth that suggests some uptick, but most measures of wage increase are running at very low levels. In fact, with productivity growth, we have, and two percent inflation, one would probably expect to see on an ongoing basis something between perhaps three and four percent wage inflation would be normal. Wage inflation has been running at two percent. So not only is it depressed, signaling weakness in the labor market, but it is certainly not flashing and increase it, and it might signal some tightening or meaningful pressures on inflation, at least over time. And I would say we're not seeing that.

rate hikes by the Fed. In short, the expected Fed rate hikes in the middle part of this decade might serve to prolong, not end the current economic recovery.

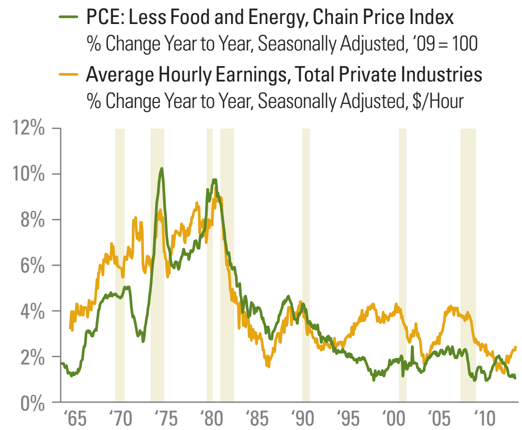
Markets have priced the first rate hike in for the summer of 2015, and by early 2017, markets expect the fed funds rate to be around 2.25%. While that is 50 basis points higher than the market had priced in as recently as the Friday before the FOMC Meeting (Friday, March 14, 2014), it is right at what the FOMC itself is forecasting. Looking back to prior series of rate hikes offers some perspective on the roughly 200-basis-point increase in the fed funds rate (from 0.25% today to 2.25% by early 2017) now expected by the market once the rate hike cycle begins:

- **In the mid-2000s,** the Fed began raising rates in June of 2004, and by June of 2005, the fed funds rate target had moved from 1.0% to 3.25%, a 225-basis-point increase. By the end of the series of rate hikes, the fed funds rate had increased by a total of 425 basis points—from 1.0% in June 2004 to 5.25% in June of 2006. During much of the time, the Fed's predominate concern was higher inflation.
- **In the late 1990s,** the Fed began hiking rates in June of 1999 when the fed funds rate target was 4.75%. A year later, in June of 2000, the fed funds rate target stood at 6.5%, which marked the high point in that cycle. Thus, in the late 1990s, the fed funds rate increased 175 basis points over the course of the series of rate hikes.
- **The early 1990s** saw a much more rapid set of rate hikes in the first year and over the course of the series of hikes than in either the mid-2000s or late 1990s. The Fed began raising rates in February of 1994 with the fed funds rate at 3.0%. A year later, in early 1995, the fed funds rate had doubled to 6.0%, which marked the high point in the cycle. At the time the inflation rate was running between 2.0% and 3.0% per year. Today, inflation is close to just 1.0% per year.

As Yellen and other FOMC members point out often, all future monetary policy is data dependent. If the economy accelerates past, or is on track to accelerate past 3.0% (the central tendency of the FOMC's forecast for the economy in 2014, 2015, and 2016), then the Fed would have to hike rates sooner and faster than the market is now pricing in. Thus, financial markets may begin to worry about a more aggressive FOMC if the economy accelerates past 3.0% for a sustained period of time. That could lead to market participants—especially bond market participants—becoming concerned that the Fed is "behind the curve" on inflation. In this context, wages, a key driver of inflation, becomes critical.

Finally, we—and many market participants—were disappointed by the lack of clarity from the FOMC in its latest round of communications. The FOMC statement released last week—at close to 900 words—was even longer than the statement released in January 2014, and is nearly ten times longer than the first FOMC statement released in 1994 (see *Weekly Economic Commentary, Making a Statement,* 03/17/14 for details). On balance, we remain concerned that the Fed faces a difficult task on the communication front over the next several months and quarters as it continues to prepare

2 Wage Growth and Core Inflation Are Tightly Correlated, Albeit Less So in the Past 20 Years Due to Globalization

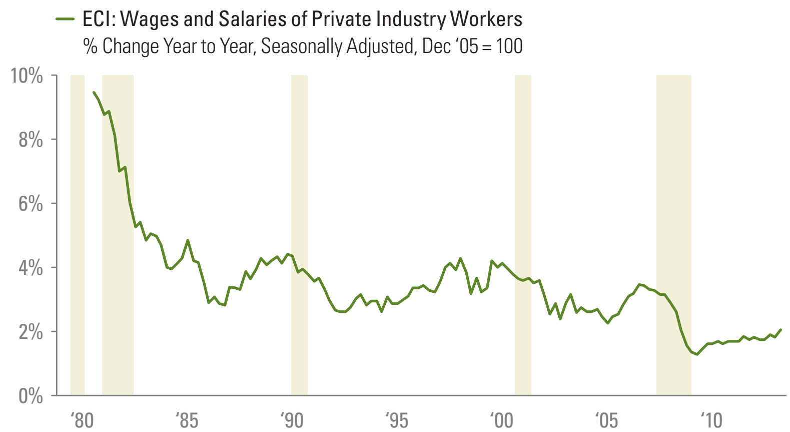


Source: LPL Financial Research, Bureau of Economic Analysis, Bureau of Labor Statistics, Haver Analytics 03/17/14

markets for the inevitable unwinding of all the monetary stimulus now in the system (low rates, quantitative easing, and forward guidance). We continue to encourage Fed policymakers to simplify Fed communications with the public, and this latest round of communications had the opposite effect. This may lead to market volatility around the scheduled events.

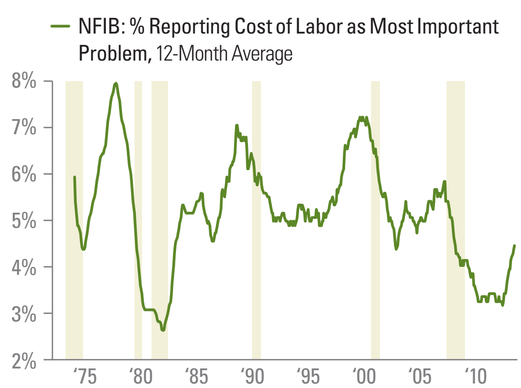
Our view remains that the Fed's first rate hike is not likely to occur until mid-to-late 2015 or later. The latest FOMC statement and Yellen's comments strongly suggest to us that the FOMC is still more concerned about slack in the economy and labor market than an uptick in inflation, and that they would likely take their time in removing the stimulus.

3 The Broadest Measure of Wage Inflation, the Wage/Salary Component of the Employment Cost Index, Remains Tame



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 03/11/14

4 The Percentage of Small Businesses Reporting Labor as a Problem Has Moved Higher, but Rising Health Care Costs and Mandates Are Likely the Cause Here



Source: LPL Financial Research, NFIB, Haver Analytics 03/17/14

The Figures 2–4 present the various measures of wages that the Fed has mentioned recently. All, as Yellen notes, are quite subdued. Wages are also prominently featured in the Fed's Beige Book (see *Weekly Economic Commentary, Beige Book: Window on Main Street,* 03/10/14). Currently, the Beige Book notes that wage pressures remain subdued, but that "upward wage pressures in some highly skilled jobs in industries such as information technology, transportation, and construction" are emerging. We would have to see the Beige Book note that wage increases were "widespread," or at least "moderate," before becoming concerned that accelerating wages was a threat to the low inflation environment.

The slack in the labor market, the slack in the U.S. and global economies, the ongoing shift toward capital replacing labor, the absence of cost of living adjustments (COLAs) in wage contracts, and the large drop in the share of union membership as a percentage of the labor force are a few of the many reasons why wage inflation remains in check. As the economy accelerates and unemployment moves closer to its long-run average, the prospect of widespread wage inflation increases. Until then, market participants will continue to monitor the incoming data for signs of an uptick in wage inflation. ■

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