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Fed remains on course

Gerhard Winzer

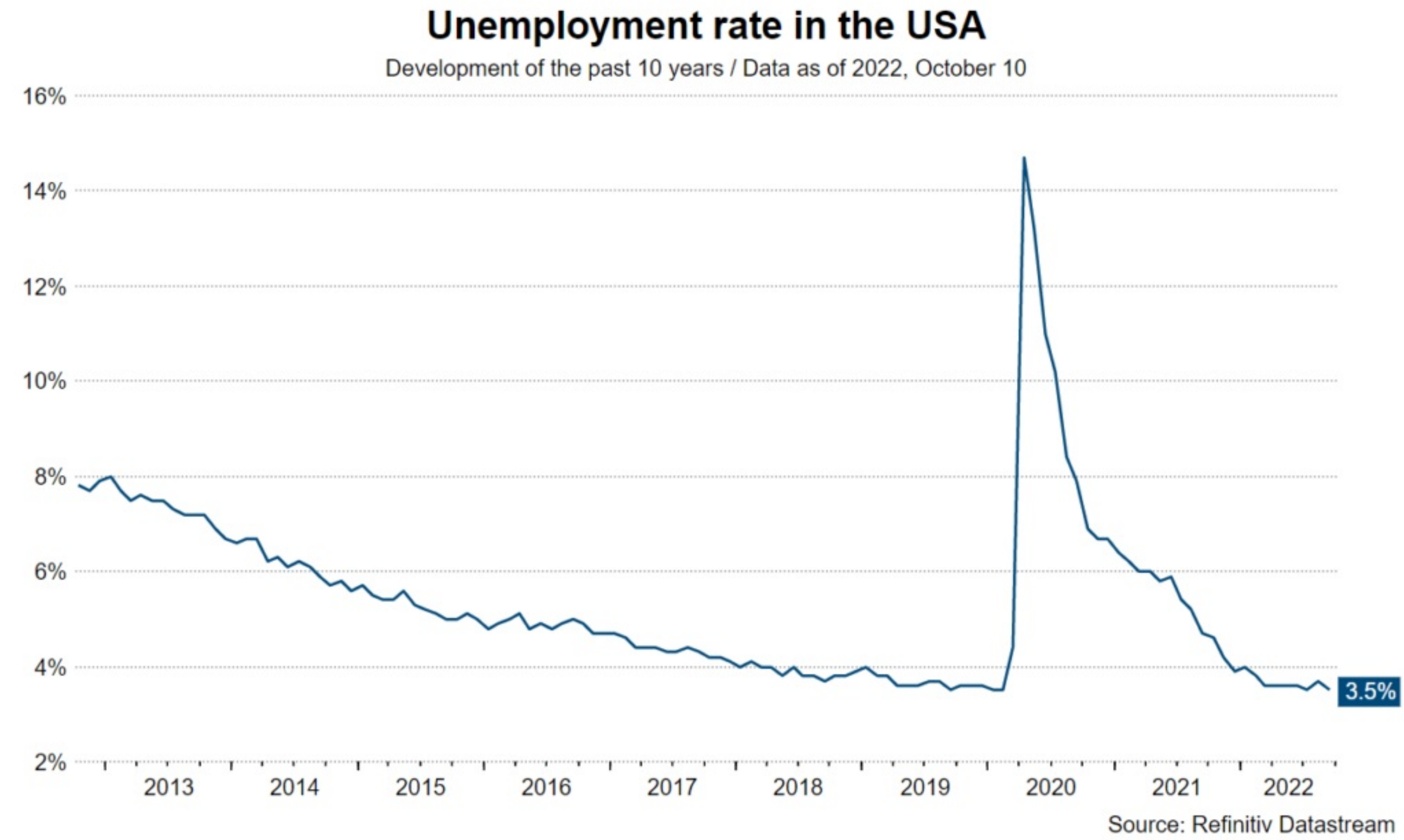
The change in expectations for future key interest rates continues to be the most important determinant of market prices. Almost two weeks ago, the liquidity crisis in British government bonds led to a rise in various stress indicators for the entire financial system. As a result, expectations for future key interest rates in the developed economies fell temporarily. This trend was reinforced by market commentary regarding an imminent reversal (pivot) of central bank policies toward a somewhat more cautious approach. However, these hopes were quickly dashed. Market prices for future key interest rates have risen once again in recent days, putting renewed pressure on the markets.

Good employment growth

As the most important central bank, monetary policy at the US Federal Reserve is in the spotlight. Indicators released last week – particularly US labor market data – suggest it is far too early for a pivot. In the month of September, nonfarm payrolls increased by 263,000, and while over the course of the year the growth in new employment has trended downward (high: 714,000 in February), the September reading is still far from a recession. Working assumption: As long as employment growth remains above a level of 100,000, the members of the Federal Open Market Committee (FOMC) will not be swayed from their restrictive stance in the current environment, which is geared toward fighting inflation.

Very low unemployment rate

Other indicators confirm this assumption. Unemployment rates were at a very low level in September at 3.5% of the labor force (sum of unemployed and employed). The Congressional Budget Office estimates the “natural” rate of unemployment at 4.4%. This means that below this level there is an increased risk of wage inflation (Phillips curve). Currently, most countries are facing first-round effects at the inflation level. The sharp rise in energy prices is being passed on to numerous other product prices. There is little central banks can do about this.

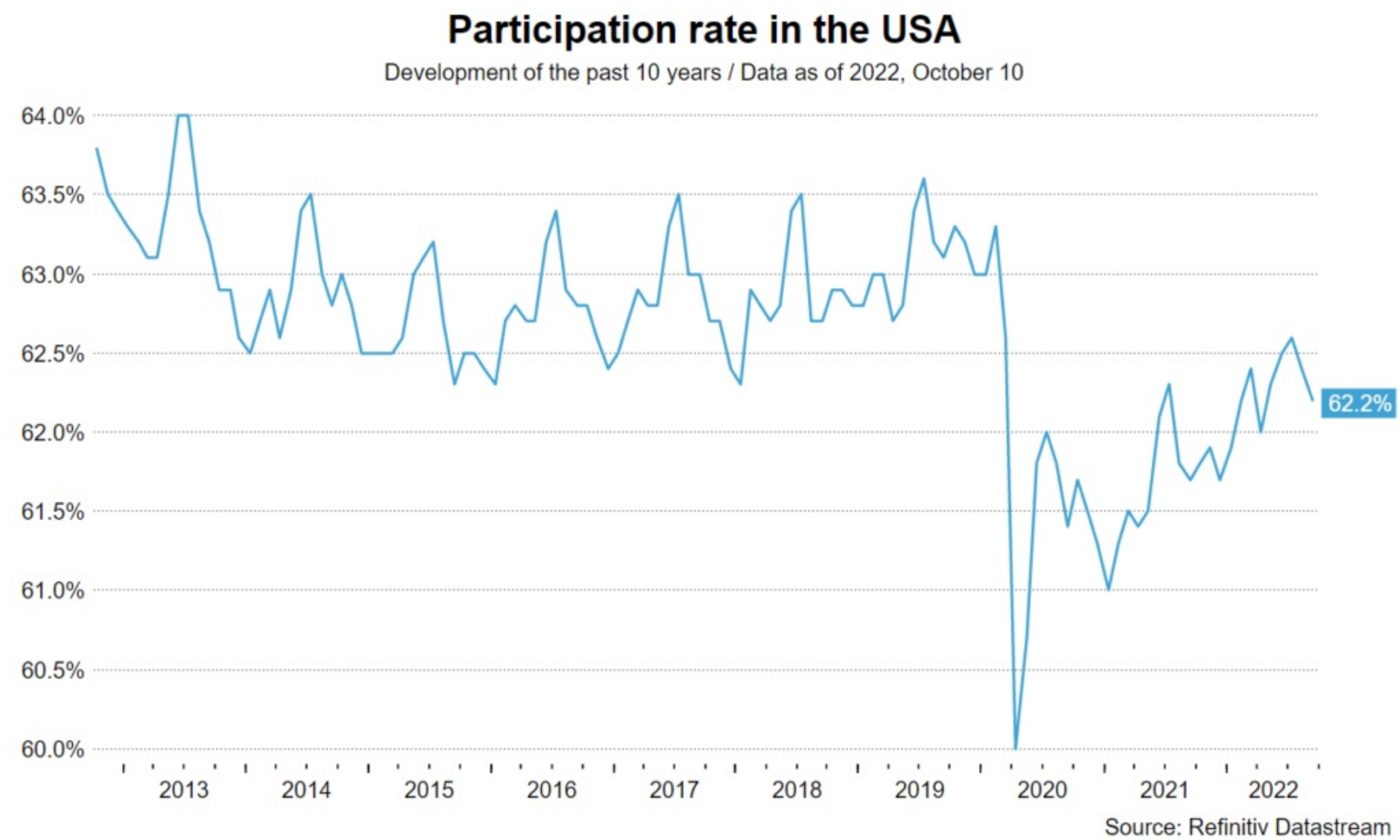


Source: Refinitiv Datastream; Note: Past performance is not a reliable indicator for future performance.

However, they can try to contain the two-round effects. Here, the focus is on the labor market. Excessive wage increases could set off a wage-price spiral. The central banks, including the Fed, are now trying to cool down (damage) the labor market with a restrictive stance to such an extent that a price spiral is prevented. In the past, however, the unemployment rate has risen sharply, not just slightly, in such an environment. The formula is: high inflation and a low unemployment rate mean high recession risks if, at the same time, central bank policy is restrictive.

Low participation rate

For the US, there is the special case that the participation rate, which is the share of the unemployed and employed (the labor force) in the working-age population, is low. The further development of this indicator will have a significant impact on the Fed's monetary policy and recession risks. Overall, the participation rate shows an upward trend after the plunge in spring 2020 (April 2020: 60.2%). The hope is that the trend will continue and soon reach pre-pandemic levels (February 2020: 63.4%).



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If more people start participating in the labor market again, the still very high demand for labor could be met more easily. The very tight labor market would ease somewhat, the risk of a wage-price spiral would decrease, and the Fed would not have to raise key interest rates so aggressively. This would increase the likelihood of a “soft” landing (low economic growth but no recession). However, the participation rate (the supply) fell slightly in the month of September (62,2% after 62.4%). This indicator is also unlikely to have appeased Fed members.

Significant decline in vacancies

On the other hand, demand has also fallen. In the month of August, job vacancies amounted to 10.05 million, compared to 11.17 million in the previous month. The ten percent decrease means a lower ratio between vacancies and unemployed persons (1.67 instead of 1.98 before). The Beveridge curve thus suggests that the labor market is still very tight, but not as tight as the month before. At least this development can be used as an argument for lower secondary round effects and thus less restrictive Fed policy. Establishing a falling trend in job vacancies would help ease the labor market. Especially if the participation rate rises at the same time.

Key interest rate hikes despite rising stress indicators

As long as job growth remains strong and unemployment and participation rates remain low, the Fed will maintain its basic restrictive stance. Signs of a decline in demand for job vacancies help, but are not (yet) decisive. Of course, the Fed is also watching the tightening financial environment and the deterioration of many liquidity indicators. However, as long as the deterioration is seen as non-systemic, the Fed (and will the other central bank) will stay on course to fight inflation. Postscript: This, however, reinforces the feedback loop from the deteriorating market environment to the economy and central bank policy, making a somewhat more cautious approach by the Fed more likely after all.

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