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North America

U.S. Economics Weekly: Market and Policy Comments

Labor Costs Put a Floor Under Inflation

- The minutes of the March FOMC meeting struck a less hawkish tone than markets had expected. At the meeting, the Fed shifted to qualitative rate guidance, but failed to convince markets this was not a change in policy. The minutes clarified that officials do not see the rising dots as an accurate assessment of policy intentions. We continue to expect the first rate hike in the second half of 2015.
- We think that the inflation outlook will increasingly become a policy focus. Policymakers intend to pursue a rate path that is below prescribed rules, but this gap may define an upside risk in the rate outlook that will depend in part on the path of inflation. Currently, inflation is running well below the Fed's official 2% goal due in part to declining goods prices. But we anticipate a gradual pickup in inflation in the coming year.
- While the labor market remains lackluster and unusual numbers of workers have been sidelined, the amount of slack has been diminishing which could yield rising labor cost growth. The number of people out of work for short durations, who have the closest ties to available jobs and wage setting, has been falling. This tightening in the labor market is likely to gradually drive up labor costs and put a floor under inflation.
- The next weekly will be published April 25, 2014. Thanks for your continuing support.

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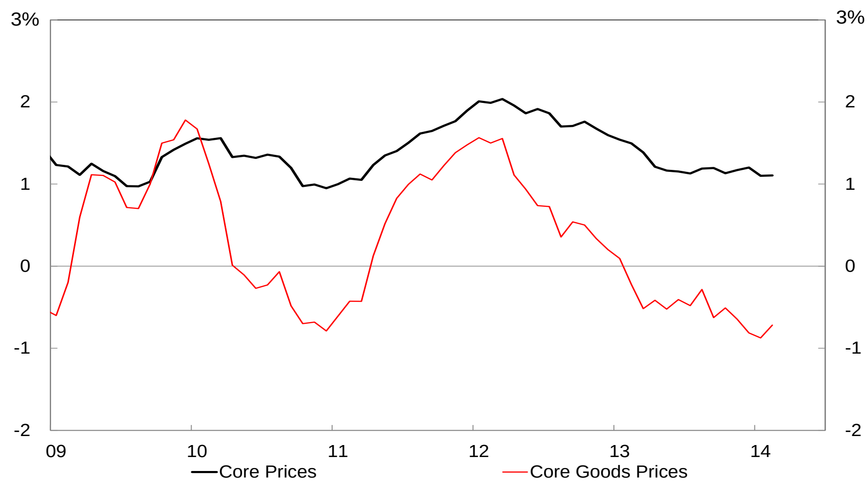
Core PCE Prices and Core PCE Goods Prices (Year-to-Year Pct. Change), 2009-Feb 14



Sources: Bureau of Economic Analysis and Citi Research.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Labor Costs Put a Floor Under Inflation

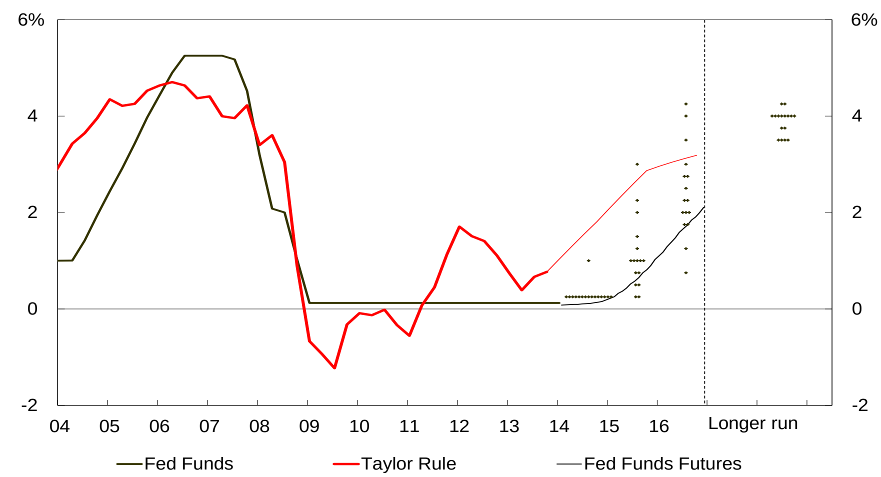
The minutes to the March Fed meeting were less hawkish than expected.

Rate markets reacted positively to the release of the March FOMC minutes this week. The discussion raised a number of issues relevant to both the immediate interest rate path and how officials view the longer term outlook. The consensus view after the meeting was that the Fed had signaled a shift toward less accommodation with their federal funds projections (the dots), and this was reflected in a rising forward rate path. The minutes, however, provided evidence that policy intentions were not as hawkish as initial interpretations.

The Fed shifted to qualitative guidance, but failed to convey unchanged policy.

The FOMC had a balancing act going into the March meeting, because it was clear that the forward guidance had to be changed. The actual unemployment rate was almost on top of the official threshold for considering rate hikes, and policymakers were not even close to contemplating hiking rates. The challenge would be to make the shift from quantitative to qualitative guidance without causing markets to sense a change in policy intentions. But the outcome of the meeting was higher rates, repeating a nagging problem that efforts at greater transparency can actually create more confusion than clarity.

Figure 1. Fed Funds Rate, Fed Funds Forwards Rate and Taylor Rule, 2004-2017F



Notes: Diamonds represent FOMC participants' judgment of appropriate level of the target federal funds rate. Fed Forecasts are used to estimate path of the Taylor rule.
Sources: Federal Reserve Board, Bloomberg and Citi Research.

The dots do not appear to be a fair assessment of policy intentions.

We had suspected that unless data forced a change in the outlook, officials would likely want to walk back the unintended message of the upward drift in fed funds projections (the dots). The minutes indicated that most officials did not believe the dots were a fair representation of the thrust of policy. FOMC participants were concerned that the projections could be misinterpreted to mean that the Committee was shifting to a less accommodative tack. Such concern flew in the face of the general market view that policy had in fact changed.

The statement is the primary vehicle for expressing policy views.

The minutes echoed the statement Chair Yellen made at the press conference cautioning that the post-meeting statement should take primacy in articulating the FOMC view on policy, rather than the Statement of Economic Projections (SEP). The latest minutes said, "the post-meeting statements, rather than the SEP, provide the public with information on the Committee's monetary policy decisions."

We look for the first rate hike in the second half of 2015.

After the meeting, we did not alter our view of exit because the core of the FOMC continued to dominate policy and made it abundantly clear in the statement that there was no shift in policy. They said explicitly, "The change in the Committee's guidance does not indicate any change in the Committee's policy intentions as set

forth in its recent statements." We don't think policymakers intended to convey a more hawkish tone at that time, and absent a change in the growth and inflation outlook we continue to take officials at their word, that rate hikes will begin in the back half of next year.

Policy is transitioning toward a less accommodative stance.

Nonetheless, the question of when they will raise rates glosses over the issue of when they should move. We think policy even now is more accommodative than it needs to be. In important respects, the scaling down of QE, the end of quantitative guidance and even the drift in dots all are indicative of a policy in slow transition. And, while officials have embraced the idea that their rate guidance is more dovish than historical relationships between policy and economic performance might prescribe, the emerging gaps between current rates and policy rules are a fair measure of the upside risks in the rate outlook **(Figure 1)**.

Rate upside depends on the outlook for inflation.

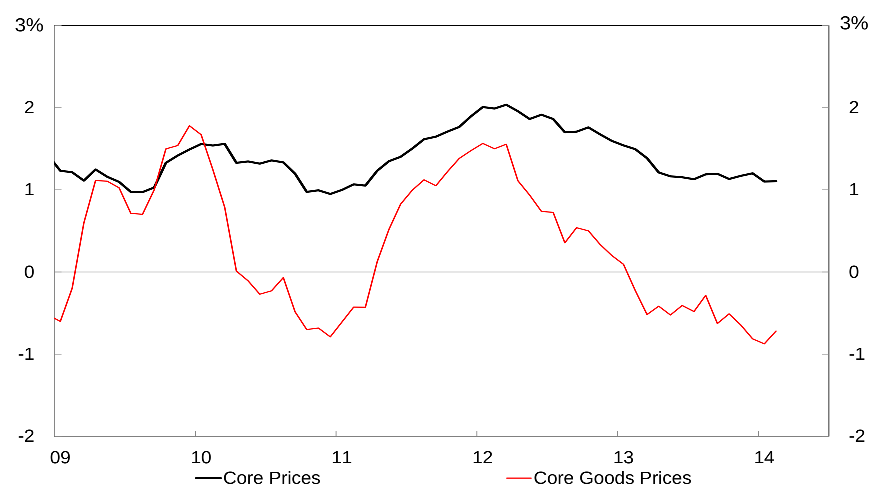
How much upside will depend importantly on the path of inflation and officials' confidence that the recent disinflation will give way to more desirable trends closer to 2%. We see good signs in labor markets that healthier wage growth will emerge as the year unfolds and some temporary disinflationary forces probably will abate.

Inflation Near Target Ahead

Core inflation has fallen below the Fed's target.

Core PCE inflation has gradually subsided from about 2% at the start of 2012 to nearly 1% two years later, which is well below the Fed's explicit 2% target. The decline in inflation has mainly reflected external or temporary forces that are likely to partially reverse this year. For example, core goods price inflation actually has declined into negative territory in the past year and is currently at -0.7% **(Figure 2)**. This slide has been evident in a wide array of products including household furnishings, apparel, and motor vehicles. We think the weakness in these prices reflects the lack of pricing power worldwide due to the global slowdown. Also, a surprising pullback in the rise in medical prices may have been a consequence of smaller Medicare payouts related to last year's sequester.

Figure 2. Core PCE Prices and Core PCE Goods Prices (Year-to-Year Pct. Change), 2009-Feb 14

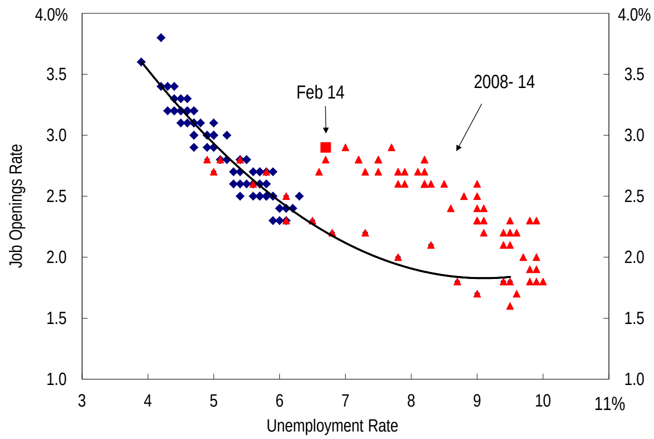


Sources: Bureau of Economic Analysis and Citi Research.

Temporary forces holding down inflation will abate.

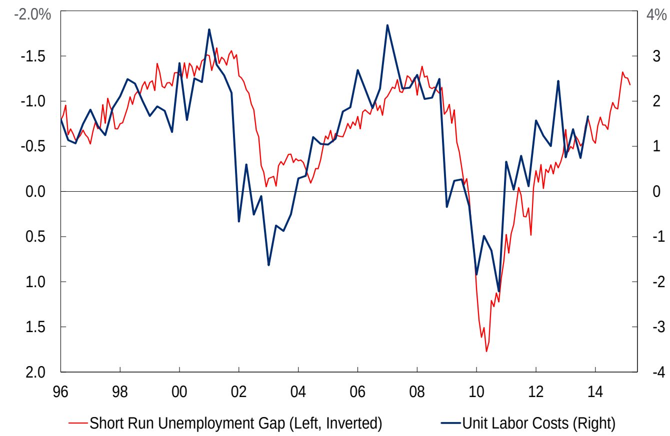
We think inflation will gradually pick up in the coming year as faster global growth helps goods producers gain pricing power, medical inflation once again reflects rising demand, and tightening labor markets exert gradual upward pressure on services prices. In addition, well anchored inflation expectations have tended to pull inflation back whenever it has swung away from trend. These forces are likely to

Figure 3. Beveridge Curve: Unemployment Rate (Percent) Plotted Against Total Job Openings Rate, Dec 00 - Feb 14



Source: Bureau of Labor Statistics.

Figure 4. Short Run Unemployment Rate Gap (Lagged 12-Months) and Unit Labor Costs (Annualized Two-Year Average Percent Change), 1996-Mar 14



Note: Short run unemployment rate gap is NAIRU minus the less than 27 week unemployment rate.
Sources: Bureau of Labor Statistics, Congressional Budget Office and Citi Research.

produce only a modest pickup in inflation, however. The inflation outlook remains tame, with core PCE running slightly below target in the next year.

We look for PCE inflation to pick up to just under 2%.

The inflation outlook also depends on the degree of tightness in the labor market. The labor market is not particularly tight right now and wage growth is extremely low (about 2%) by historical standards. However, the labor market seems to be tightening gradually in key areas which should eventually generate a pickup in wage growth and underpin modest inflation.

The labor market continues to show signs of weakness…

There is no question that the labor market has fallen short on a number of metrics, indicating unusual weakness for this point in a business cycle. Gross hiring is lackluster. Labor force growth is inadequate as large portions of the populace are choosing to sit on the sidelines. Job openings are failing to draw from the ranks of unemployed, indicating a mismatch of skills **(Figure 3)**. Many people are unwilling to quit current jobs to find better ones. A large number of people have been unemployed long term. Also, the unemployment rate, at 6.7%, remains well above equilibrium after nearly five years of expansion.

…with a lot of sidelined workers…

However, we want to make a distinction between the health of the labor market and its tightness. The following statistics show that labor market improvement is falling short on a wide range of metrics during this recovery. For example, there are 10.5 million unemployed workers at this time and nearly 4 million of them have been out of work for half a year or more. These workers' prospects have been marginalized by extended bouts of joblessness. In addition, a large number of people are choosing to leave (or not enter) the workforce. Since the recovery started, the labor force has increased by just 1.5 million, while the number not in the labor force has increased by 11 million. By comparison, at this same point in the previous recovery, the labor force had increased by 7.5 million and the number not in the labor force was up by 4.8 million.

…but there isn't a lot of slack either.

Normally a labor market that exhibits such signs of weakness would also have a lot of slack, as the sidelined workers provide a reservoir of spare labor market capacity that can hold down wages. However, a huge proportion of the people who remain sidelined in the current environment have only weak ties to the job market. The long

term unemployed and those who left the workforce (especially retirees) are less likely to compete for jobs or act as a counterweight to wage increases.

The drop in short term unemployment implies higher labor costs.

Instead, we look to the 6.7 million people out of work for short durations (less than six months), as this group seems to have closer ties to available jobs and wage setting. The short term unemployment rate now is just 4.2%, which is getting to levels consistent with full employment. Unit labor costs have kept pace with the drop in the short term unemployment rate **(Figure 4)**. Business surveys indicate that firms are beginning to raise compensation levels **(Figure 5)**, which is not surprising. The economy is well past the point where a cyclical lift in productivity would shield firms from bidding for workers. We expect further labor market tightening over the next year or so, which should gradually drive up labor costs and put a floor under inflation.

Figure 5. Percent of Small Businesses that have Raised Worker Compensation Over Past 3-6 Months and Private Hourly Earnings (Year-to-Year Percent Change), 1988-Mar 14

Sources: National Federation of Independent Business and Bureau of Labor Statistics.

April-May 2014

Monday	Tuesday	Wednesday	Thursday	Friday
7 Consumer Credit Jan $13.8B Feb $16.5B Auction 3 & 6 Mth. Bills: $48.0B	8 Small Business (Mar) Auction 3-Yr. Note: $30.0B Auction 1 Mth. Bill: $25.0B	9 Mortgage Applications Wholesale Inventories Jan 0.8% Feb 0.5% FOMC Minutes Released Auction 10-Yr. Note(r): $21.0B	10 Jobless Claims 4/5 300 Thous Import Price Index Total ExPetro Feb 0.9% 0.1% Mar 0.6% 0.6% Federal Budget Balance Mar 13 -$106.5B Mar 14 -$36.9B Ann. 5-Yr: TIPS: $18.0B Auction 30-Yr. Bond(r): $13.0B	11 Producer Price Index Final Demand ExF&E Feb -0.1% -0.2% Mar 0.5% 0.6% Reuters/Michigan Sentiment MarF 80.0 AprP 82.6
14 Retail Sales Total ExAuto Feb 0.3% 0.3% Mar(E) 0.9% 0.5% Business Inventories Jan 0.5% Feb(E) 0.5% Auction 3 & 6 Mth. Bills: $48.0B(E)	15 Consumer Price Index Total ExF&E Feb 0.1% 0.1% Mar(E) 0.1% 0.2% Real Earnings (Mar) Empire State Manufacturing Mar 5.6% Apr Housing Market Index Mar 47 Apr Auction 1 Mth. Bill: $25.0B(E)	16 Mortgage Applications Housing Starts and Permits Feb 907K 1,014K Mar(E) 930K 1,010K Industrial Prod. & Cap. Util. Feb 0.6% 78.4% Mar(E) 0.3% 78.6% Beige Book	17 Jobless Claims 4/12 310 Thous(E) Philly Outlook Survey Mar 9.0% Apr(E) 7.0% Ann. 2-Yr. Note: $32.0B(E) Ann. 5-Yr. Note: $35.0B(E) Ann. 7-Yr. Note: $29.0B(E) Auction 5-Yr. TIPS: $18.0B(E)	18 Good Friday NYSE Holiday
21 Leading Indicators Feb(R) 0.6% Mar(E) 0.8% Auction 3 & 6 Mth. Bills: $48.0B(E)	22 FHFA (Feb) Existing Home Sales Feb 4.60M Mar(E) 4.50M Auction 2-Yr. Note: $32.0B(E) Auction 1 Mth. Bill: $25.0B(E)	23 Mortgage Applications New Home Sales Feb 440K Mar(E) 450K Auction 5-Yr. Note: $35.0B(E)	24 Jobless Claims 4/19 315 Thous(E) Durable Goods Orders Total ExTrans Feb 2.2% 0.1% Mar(E) 0.9% 0.3% Ann 2-Yr. FRN: $15.0B(E) Auction 7-Yr. Note: $29.0B(E)	25 Reuters/Michigan Sentiment AprP 82.6 AprF(E) 83.0
28 Pending Home Sales (Mar) Auction 3 & 6 Mth. Bills: $48.0B(E) Auction 2-Yr. FRN: $15.0B(E)	29 S&P/CaseShiller (Feb) Consumer Confidence Mar 82.3 Apr(E) FOMC Meeting Auction 1 Mth. Bill: $25.0B(E)	30 Mortgage Applications ADP Employment Mar 191K Apr(E) Employment Cost Index Q/Q Y/Y 4Q13 0.5% 2.0% 1Q14(E) GDP & Chain Price Index 4Q 13F 2.6% 1.6% 1Q14A(E) Chicago Barometer PMI Prices Mar 55.9 55.7 Apr(E) Farm Prices (Apr) FOMC Meeting Ann. 3-Yr. Note: $30.0B(E) Ann. 10-Yr. Note: $24.0B(E) Ann. 30-Yr. Bond: $16.0B(E)	May 1 Jobless Claims 4/26 Personal Income & Consumption Feb 0.3% 0.3% Mar(E) Construction PIP Feb 0.1% Mar(E) ISM Manufacturing PMI Prices Mar 53.7 59.0 Apr(E) Total Vehicle Sales Mar 16.3M Apr(E)	2 Employment Mar Apr(E) Payrolls 192K Unemp. Rate 6.7% Avg. Hrly. Earn. 0.0% Priv. Wrkwk 34.5H Factory Orders Ord. Inv. Feb 1.6% 0.7% Mar(E)

(E) Indicates Citigroup estimates. (A) Advance. (P) Preliminary. (F) Final. (UNCH) Unchanged. (R) Revised. Contributors: Martha Berasain and Cathy Gaeta.

Notes

Notes

Appendix A-1

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