Laboring Over Rates

Decisions at the Federal Reserve (Fed) have wide-ranging implications for investors across the globe. When Federal Reserve Board Chair Janet Yellen presides at the Federal Open Market Committee (FOMC) meetings in November and December, she will face a difficult decision on whether to raise interest rates. In this article, we will focus on one input to the Fed’s decision—the labor market. Then we will review the potential impact on asset classes and on broader market sentiment.

Dual Mandate

The Fed has a dual mandate of providing stable prices by managing inflation as well as maximizing employment. For our focus, we examine the goal of maximizing employment.

The broadest measure of unemployment is produced each month by the U.S. Bureau of Labor Statistics and stands at 5.0% as of September 2016, which is below the 20-year average of nearly 6.0% and nearly equal to the rate just before the 2008 financial crisis. But what about other employment indicators, such as the size of the overall labor force, workers that have part-time but want full-time jobs, or the quality of jobs being created?

More Useful Dashboard

In 2014, the Fed created an index of 19 labor-market indicators called the Labor Market Conditions Index (LMCI) to assess the overall health of the labor market using calculated index values going back to 1979. This tracking tool has since become an important part of the data-driven “dashboard” that Janet Yellen consults to provide greater transparency to markets about upcoming policy decisions. The goal has been to enable more effective guidance to prevent surprising investors.

Understanding the LMCI

Interestingly, the Fed doesn’t actually provide an index level—just monthly changes in the level. However, this data was enough for us to construct our estimate of the index. In Figure 1 we show the index level (based upon our estimated calculation) along with the periodic peaks in the labor market that are often followed by recession, represented by the shaded regions in the chart.

How does inflation figure into the Fed’s decision?

The Fed is concerned with the future path of inflation and has defined its target inflation rate (excluding volatile energy and food prices) at 2.0% per year. The Fed’s data-driven approach means that as market expectations for future inflation rise above the 2.0% target, the Fed should consider an interest-rate hike, and vice-versa. Expectations for future inflation are currently below the Fed’s target.

We are specifically interested in what the Fed has done in response to past peaks. Figure 2 shows the peaks from the prior chart superimposed as vertical lines on the federal funds rate.

**Figure 2. LMCI Peaks and Policy Rate**

Peaks in the LMCI have prompted the Fed to cut interest rates in the past. This makes sense, as the Fed wants to make borrowing and lending conditions easier for banks, businesses, and consumers leading into a recession in an attempt to reduce its length and depth. The data suggest that the Fed may need to weigh an interest-rate cut if conditions do not improve.

**Central Banker Currency**

Capital markets are driven by expectations about what will happen in the future, and the main currency of the central banker’s toolkit is, therefore, its credibility. The Fed’s “dot plot” provides guidance to help the market better understand its intentions for the future path of interest rates.

What is the “dot plot”?
The Federal Reserve dot plot shows the policy-rate projections of 16 members of the FOMC, during the next three to four years. Intended as a tool to provide both forward guidance and policy clarity, the dot plot has instead harmed Fed credibility as the FOMC has consistently overestimated the path of the policy rate since it began publishing the dot plot in 2012.

Figure 3 shows each Fed forecast of future interest rates for the 2016 year-end compared to the market’s estimate. In September 2014, the consensus view for the year-end 2016 Fed rate was nearly 3.0% as shown by the circled point in Figure 3. That number was 1.0% higher than markets had priced in at the time, which was more than 1.0% higher than either the Fed or the market estimate today. Although the Fed has continually lowered its rate forecast since the September 2014 meeting, the market continues to price in odds of even fewer rate hikes.

**Figure 3: Fed vs. Market 2016 Rate Outlook**

Source: Bloomberg, September 2016.

At some point, market participants may conclude that they can disregard the guidance provided by the Fed. This would impair the Fed’s ability to provide credible forward guidance. In other words, the Fed’s so-called “open mouth operations” would no longer be effective in impacting intermediate and long-term interest rates. As we explored in our last Manager Insight Series article about negative interest rates in Europe and Japan, the less credible the words of the central banker, the more extreme the necessary policy tools needed to impact markets. More extreme policy tools may also lead to more unanticipated consequences that spell the potential for future asset bubbles and volatility.

**What to Do?**
The most likely match between the data the Fed watches and the expectations it has set would be to see one hike in 2016 as an effort to maintain credibility, followed by a longer-than-anticipated period before the next hike and a shallow path for future rate hikes. This anticipated strategy has implications for a number of asset classes as well as for broader market sentiment.
Risk-Taking

We think the Fed’s predicament means it will be walking a fine line between promoting excessive risk-taking with low interest rates and choking off a recovering economy by hiking rates when the dashboard indicates otherwise. For investors, positions in higher-yielding assets like lower-grade corporate credit, utilities, and real estate investment trusts may have some room to run before they face serious headwinds from rising interest rates. However, given the run-up in valuations for higher-yielding assets, it may make sense to diversify these riskier positions. Core bonds may also remain helpful diversifiers and should continue to be negatively correlated to equities in extreme sell-offs.

Emerging Markets

If the Fed is frozen by its conflicting need to maintain credibility and remain data-driven, equities may finally reflect the fundamental realities of business like revenue and earnings growth, which have been challenged in the U.S. However, a shallower Fed path may be especially impactful for emerging markets (EM), as growth in many EM countries should not face the headwind of a rising U.S. dollar. Additionally, trade connections between emerging market economies have deepened and they may be more resilient in the face of potentially slower demand from developed countries still trying to boost economic growth.

Conclusion

The data from the labor market suggest the Fed should be contemplating a rate cut. However, the Fed’s exhausted credibility indicates it should implement a rate hike to follow through on what has otherwise been empty guidance. We see this combination providing the case for a single rate hike by year-end and a shallow path for future rate hikes. For investors, this means the rally in higher-yielding securities may have some room to run, although it may be wise to diversify riskier positions as valuations have inflated. And finally, we feel this will allow equity markets to return to focusing on fundamentals and not solely on what central banks will do, with the largest advantage likely going to emerging markets.

¹The index tracks changes in the labor market and is derived from a dynamic factor model that extracts the primary common variation from the following 19, seasonally adjusted, labor-market indicators: unemployment rate, labor force participation rate, part time for economic reasons, private payroll employment, government payroll employment, temporary help employment, average weekly hours (production), average weekly hours of persons at work, average hourly earnings (production), composite help-wanted index, hiring rate, transition rate from unemployment to employment, insured unemployment rate, job losers unemployed less than 5 weeks, quit rate, job leavers unemployed less than 5 weeks, jobs plentiful v. hard to get, hiring plans, and jobs hard to fill.

²We covered negative interest rates in our September 2016 Manager Insight Series article titled “Negative Interest Rates: Staying Comfortable Below Zero.”

³A shallow path indicates fewer rate hikes spread further apart.

⁴Refers to bond funds that act as the centerpiece of your bond fund investments. They are generally well-diversified across the investment grade U.S. market, which includes U.S. government, agency, and mortgage-related bonds. A core bond fund can be the only bond fund an investor holds, or the anchor bond fund in their portfolio, which is then supplemented with other investments in other bond funds like emerging markets and high yield bond funds.
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