

US: When will the Fed rate rise?

This flash note focuses on how the US labour market can potentially influence monetary policy going forward. Using a composite index of Janet Yellen's reference indicators, our Taylor rule estimates support a delay in tightening beyond what one would find simply using the unemployment rate. Assuming a tepid labour market improvement and accounting for the expanded list of indicators, we anticipate a US policy rate hike in 2015Q2. Nonetheless, a stronger recovery in employment conditions could push forward this date to as early as 2014Q4. Hence, anticipate financial market volatility to heat up as we approach the remaining months of the year.

A conclusion to QE3 is expected in autumn. This begs the question: When will the US Fed Funds rate be hiked? In early 2013, Janet Yellen, Federal Reserve chair, replaced the forward guidance unemployment target rate of 6.5% with a dashboard of labour indicators to help drive upcoming monetary policy decisions. Moreover, she announced that interest rate increases could begin in 2015H1, "around six months after it winds down its bond-buying program" depending on its objectives of maximum employment and 2% inflation.

We investigate this question, as some signs already suggest potential pressure on the Fed rate to increase sooner than expected.

- Despite revised downward GDP growth for 2014Q1 (2.0% y/y), US GDP growth should progressively increase toward its potential of around +2.7% in 2014, according to our models. The unemployment rate also continues to steadily decrease, reaching 6.3% in April.
- Fed foresees inflation rate to remain below 2% this year. However, our quantitative models signal a potential increase above 2.5% through 2014H2. This scenario is supported by a record-low short-term unemployment rate and positive wage gains, as well as other leading inflation indicators.

Labour market indicators diverging

A crucial question concerns how much slack remains in the US labour market, as Yellen

suggests taking into account a large range of labour indicators.

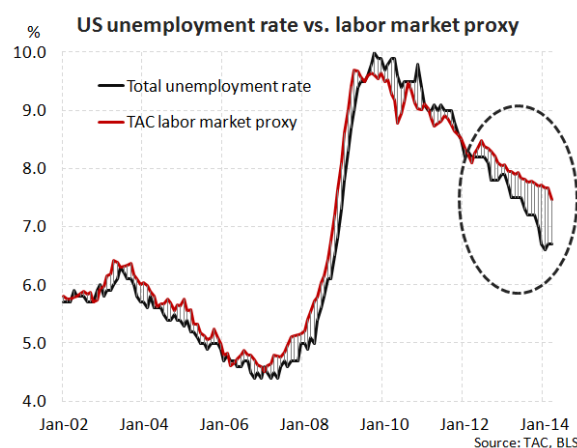
Yellen labor market indicators

	Trend	Last month ^(*)
Unemployment rate	+	6.3% (4.8%)
U-6 unemployment rate(**)	-	12.3% (8.5%)
Job openings rate	=	2.8% (3.1%)
Change in nonfarm payrolls	++	288 (159)
Long-term unemployed share	--	35.3% (18%)
Labour force participation rate	--	62.8% (66%)
Layoffs/discharges rate	+	1.1% (1.3%)
Quits rate	=	1.8% (2.1%)
Hires rate	=	3.4% (3.8%)

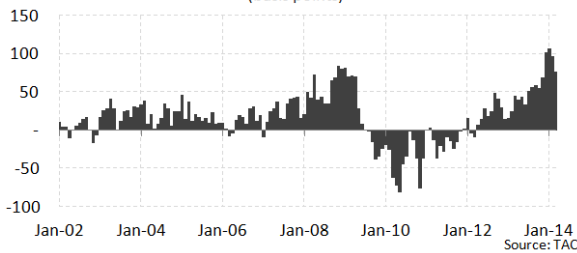
(*) pre-recession levels in parentheses, 2005-2007 average
 (**) includes part-time workers who want a full-time job and those not in the labour force who would take a job if one were available

In fact, some of the recent figures presented on the table above have improved, such as the unemployment rate (+6.3% in April) and nonfarm payrolls (288,000 persons in April) whereas other indicators have shown little progress while remaining far from pre-recession levels, particularly with respect to the labour participation rate (April: 62.8%) and the long-term unemployment rate (35.3% against 18% over the 2005-2007 period).

To better illustrate labour market health, we take into account these additional nine indicators (see table above) and construct a labour market composite index. Interestingly, although our labour market proxy and the unemployment rate have historically been highly correlated, there has been an increasing gap between both indicators since the beginning of 2012, revealing a slower improvement in the "labour market proxy" relative to the total unemployment rate.

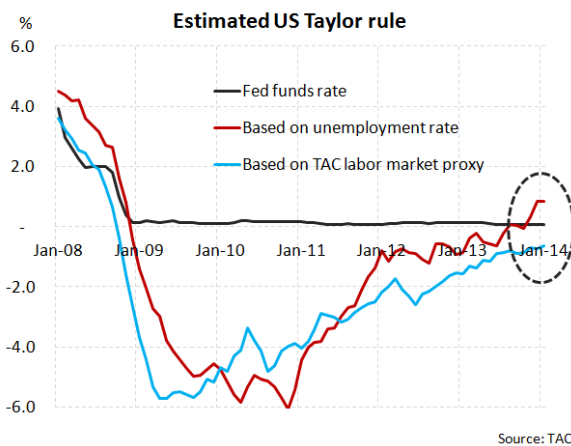


June 4, 2014

Spread labor market proxy and unemployment rate
(basis points)

An adjusted Taylor Rule

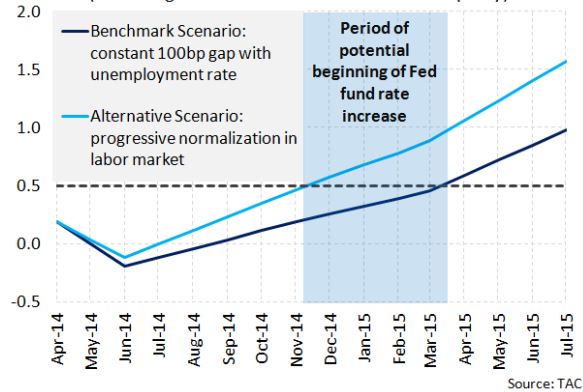
We evaluate the impact of this labour market proxy on the potential course of Fed Funds rates by estimating a Taylor rule, a key metric used by central bankers for monetary policy evaluation. This rule establishes serves as a simple and transparent formula that sets the targeted level of the short-term nominal interest rate to inflation and the NAIRU (Non Accelerating inflation rate of unemployment) gap. We also compared this rule with the more “traditional” one wherein only the unemployment rate is considered rather than our labour market proxy.



Indeed, while both estimates were in negative territory from end-2008 onwards (the exact starting date of QE), they clearly diverge from end-2012 and more recently from end-2013, as the Taylor estimate based on total unemployment already calls for an increase in the Fed funds rate.

We forecasted our labour market proxy by assuming a steady decline of the unemployment rate towards 6% by mid-2015 and an increase in inflation above 2.5% in 2014H2 (Consensus is expecting 1.8%, see the Monthly of April for more details on TAC scenario on inflation). We then added a premium related to the gap observed between the proxy and unemployment

rate and two different scenarios were tested: (1) a constant 100bp gap, as observed end-2013 and (2) progressive convergence of the labour market proxy towards the unemployment rate, given a 20bp gap reduction every month as observed since the beginning of 2014.

TAC Taylor rule projections
(according to scenarios on the labor market proxy)

Our results show that the Benchmark scenario is supportive of a March-April 2015 rate hike, while the alternative scenario points to rising pressure on the Federal Reserve to tighten sooner, beginning in 2014Q4. However, our internal models suggest that if the FED decides not to follow the ‘revised’ Taylor rule in the case of the optimistic scenario (rates rising in 2014Q4) this should impose added pressure on inflation. Finally, our outlook for US activity supports a progressive normalization of long-term interest rates that should materialise in the second half of 2014. A consequence of this outcome, combined with an unexpected increase in inflation, will increase volatility in most asset classes as we approach the end of the year.