When will the Fed tighten rates and what will it mean for markets?

With last month’s surprisingly high U.S. core CPI inflation print (0.9% month-over-month vs. expectations of 0.3%), inflation has quickly become the focus and concern of markets. For example, the latest Bank of America Merrill Lynch Fund Managers’ Survey listed “inflation” as the biggest tail risk.

Fed Chairman Jerome Powell noted that roughly a million jobs were added in March after including revised jobs data from January and February — lowering the unemployment rate from 6.2% to 6.0%.

“We would like to see a string of months like that,” he said.
“That is certainly in the range of possibility.”

— USA Today, April 12, 2021.

As outlined in our May 2021 Market Insights, data as of April 2021 had been heavily distorted by one-off re-opening factors. Our view is that the concern about inflation in the second half of 2021 is overdone. However, beyond that time frame, the outlook is more troubling.

There’s a monetary aspect to the potential inflation risks. That is, the M2 money supply has been growing at multi-decade record high growth rates (the highest since WWII). Changing demographic factors are also likely to have an effect, such as the rising impact of American millennials. For instance, a key medium-term inflation concern is the link between the growth in “working age” millennials and the rise in money velocity. Finally, there’s also a potential impact from the renewed health of the banking system.
In addition to those factors, and critical to the Fed’s thinking about tapering and rate hikes, is the health of the labor market. In Jerome Powell’s words, “we’re eight million jobs below February 2020,” and until there’s been a “string” of monthly million-plus job gains, the Fed isn’t going to discuss raising rates.

On the surface, eight million is a lot of lost jobs. During the Great Recession (financial crisis of 2007–09), nine million jobs were lost (peak to trough, see Figure 1) — and those jobs weren’t recovered for seven years (until October 2014, which was over five years after the end of the recession). If that’s the correct template for today, the Fed has considerable runway until the labor market will start to seem tight.

**Figure 1: During the financial crisis of 2007–2009, nine million jobs were lost peak to trough**

U.S. total number employed (millions, aged 16 and over)

However, this is not like a typical recession. The COVID-19 event was a health and economic shock. Policy successfully bridged the economy across the downturn in a way that also deterred banks from reinforcing the shutdown and creating the usual negative feedback loops that occur as credit conditions tighten. Added to this, the government has supported company wage bills — either through furlough funds (PPP) or enhanced unemployment benefits (such that many low-income workers make more money unemployed than working). As a result, the supply side of the economy has been protected. At the same time, householders’ incomes have also been protected, with cash incomes in April 2020 up 40% and bank accounts with between $2–$3 trillion of extra cash awaiting the unlocking of the economy. While the policy support in other major economies has been smaller as a share of GDP, furlough schemes have been effective and corporate sectors have been kept alive (e.g., in Germany, the United Kingdom, and China).

Because of government policy, the supply side has been protected and the demand side elevated. And, with that, the normal recessionary dynamics have been averted. In other words, this has been a “shock” event from which the economy is recovering swiftly.
As the U.S. economy unlocks, consumer-facing service sector businesses are expected to quickly re-employ (or remove from furlough) those employees currently registered as temporarily or permanently unemployed — with the result that those eight million people are swiftly back working. In other words, the labor market should quickly tighten back to its pre-pandemic state.

There is evidence to support the expectation that the labor market will recover quickly, including the following:

1. **A significant majority of the jobs lost since the start of the pandemic have been in consumer-facing employment.** If we break down the eight million in lost jobs, the “leisure and hospitality” sector represents 2.85 million (roughly 36% of the total jobs lost) — but only accounts for 11% of total employment. “Education and health services” represents an additional 15% of lost jobs (another 1.17 million), while “professional and business services” accounts for 750k lost jobs. These three sectors alone represent 4.8 million of the eight million total jobs lost. Given the successful protection of the supply side of the economy, many of these workers should quickly find employment as the economy unlocks and businesses re-open.

2. **Consistent with the expected swift re-employment of many laid-off workers, the job openings rate is at record high levels.** Recent data shows there are 9.3 million job openings (Figure 2), which is the highest on record. Relative to the continuing claims (i.e., the number of unemployed who are receiving benefits), the ratio is high (above pre-financial crisis levels) — although below record highs of 2017–19.

**Figure 2: The job openings rate is at record high levels**

U.S. job openings (in millions)

Sources: Longview Economics, Macrobond, May 2021.
3. Other market indicators highlight the tightness in the labor market. Those include the “quit rate,” which measures the percentage of workers who voluntarily left their jobs. If a worker voluntarily leaves their job, it’s typically an indication that they are confident about finding other vacant positions. The quit rate is currently at its recent highs from 2019 and just shy of the record high prior to the 2001 recession. Further reinforcing the message of labor market tightness, the quit rate of the “leisure and hospitality” sector (the sector with the biggest job losses) is also at relatively high levels. And the ratio of “jobs plentiful to jobs hard to get” has moved sharply higher this year. Looking at the other side of the coin, the “corporate” sector’s desire to shed labor is at record low levels, as shown by the latest lay-off numbers, which have been running at record low levels for several months.

All of this likely explains why median wage inflation (as measured by the Atlanta Fed) has remained reasonably stable compared to prior recessions when it fell sharply — either during or immediately after the recession. So far, that rate has held up* (see Figure 3).

**Figure 3: Median wage inflation has remained reasonably stable compared to prior recessions**

*The average hourly earnings rate, in contrast, fell sharply in April. That primarily reflects statistical quirks in April 2020 and subsequent base effects, which should quickly dissipate from the annual growth rate. As low-income workers were laid off in April last year, the average hourly earnings was boosted/distorted by their absence.*
So, what’s next?

All the evidence suggests that one of the surprises of this recovery (vs. prior recoveries) will be the speed (as we get into 2022) at which the Fed feels obligated to tighten monetary policy.

The Fed started quantitative easing (QE) in 2008 during the financial crisis. It then continued with a stop/start QE program through 2014. It wasn’t until the end of 2014 that it finished its tapering and completed its QE program. That is also how long it took the U.S. labor market to reach its pre-financial crisis employment peak (refer to Figure 1). If that pace is any yardstick, we expect the Fed’s QE program will be completed much sooner this time around and likely by the end of next year (if not before). By that stage, the eight million lost jobs should have been replaced, and we would expect the labor market to seem tight once again.

If this expectation is correct, the Fed will likely feel obligated to begin tightening interest rates in late 2022 or early 2023.

If this expectation is correct, the Fed will likely feel obligated to begin tightening interest rates sometime in late 2022 or early 2023. With the S&P 500 forward price-to-earnings (P/E) ratio currently at 22x, the equity market is richly valued, which is likely to cause significant headwinds for equity markets. While the economy should be underpinned by strong economic and earnings growth, the P/E ratio will lose some of its support from cheap money/QE. In that environment, further advances in the stock market become dependent on the economy growing more swiftly than the P/E is shrinking.

Monitoring the differing pace of the drivers of those two key factors will be critical for forecasting the outcome of the equity market in 2022. One school of thought is that the stock market is in a bubble. In contrast, if the economy maintains above-average growth rates and achieves low inflation, the Fed’s pace of removing monetary accommodation and raising interest rates will likely be markedly slow. Furthermore, while tight labor markets are inflationary, accelerated productivity growth is disinflationary. The U.S. economy has behaved impressively with productivity accelerating rapidly out of the pandemic (1Q21 final productivity data shows a +5.4% annualized growth rate). This growth may reflect the rapid adoption of new technologies (for example “work-from-home” and other trends arising from the pandemic). Equally, it may be transitory and simply mirrors the classic productivity trend at the start of recoveries.

For now, the labor market is not yet tight, inflation appears transitory, and the Fed/Powell continue to wait for a “string of million-plus job gains.”
Definitions

U.S. Core Inflation is the change in the costs of goods and services but does not include those from the food and energy sectors. Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods. Bank of America Merrill Lynch Fund Managers’ Survey is supported by the BofA Data Analytics team to provide insightful, objective, and in-depth research to help investors make informed investing decisions. M2 Money Supply is a measure of the money supply that includes cash, checking deposits, and easily convertible near money. M2 is a broader measure of the money supply than M1, which just includes cash and checking deposits. Paycheck Protection Program (PPP) is a Small Business Association-backed (SBA) loan that helped businesses keep their workforce employed during the COVID-19 crisis. Quantitative Easing (QE) is a form of unconventional monetary policy in which a central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment. Forward Price-to-Earnings (P/E) Ratio is a version of the price-to-earnings ratio that uses the expected future earnings of a company rather than the reported or historical earnings.

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