



INVESTMENT UPDATE

As we wrote last month, we're at the point in the economic cycle where we should begin to see an uptick in inflation—especially in wage inflation—but for various reasons, it's just not happening. This has important implications for policymakers, especially the Federal Reserve, an organization that values process and structure over pragmatism. The Fed is expected to move slowly and predictably, lest they spook the capital markets, consumers and businesses, all of whom look to the Fed to keep a steady hand on the till.

The Fed, like most financial-minded organizations, relies on certain economic truths, most of which boil down to the immutable laws of supply and demand, which state that the more of a "good" that's available, the lower the price of that "good." Conversely, prices of things should rise when they become scarce.

In the case of the labor market, the main supply-demand equation policymakers look to is called the "Phillips curve" (named, surprisingly enough, for an economist named Phillips) which maintains that there is an inverse relationship between the available supply of labor and the cost to employ that labor.

Fundamentally, the Phillips curve is perfectly logical. As the unemployment rate declines in the expansionary phase of an economic cycle, employers with job openings will have to progressively increase the wages offered to workers in order to induce them to switch jobs, or rejoin the labor force if they've dropped out (e.g., working moms who've decided to stay home and raise young kids). Eventually, wages rise enough to attract the workers in the quantity that are needed to fill the job openings, and the "natural" rate of unemployment is reached.

That's the theory, at least. But here in the real world, the Phillips curve hasn't been working lately, as wages haven't been

rising, despite an unemployment rate that's fallen from 10% to the current rate of 4.3% during this recovery. An unemployment rate this low is extraordinarily rare—since 1970, we've only seen an unemployment rate below 4.0% for a total of four months in late 2000. As the charts below show (with thanks to Chris Low at FTN Financial), recently the Phillips curve has had more intuitive appeal than real-world application. The charts on the left show that in the 60's and 70's there were times when a falling unemployment rate (moving from right to left on the bottom axis) led to rising inflation ("Core PCE"). But that relationship hasn't held up since the 70s, and the most recent data shows almost no correlation

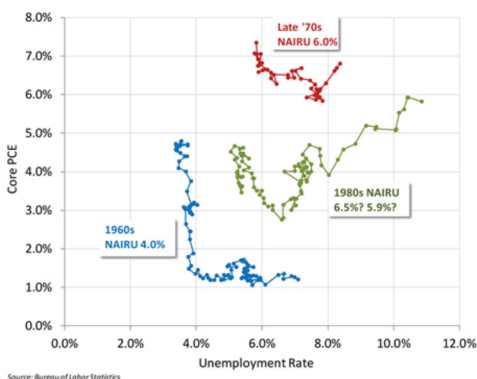
between unemployment and inflation.

One factor that might help explain the disconnect between economic theory and the real world is that the level of unemployment that

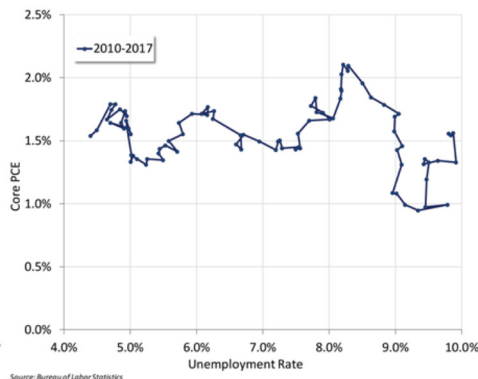
spurs an increase in wages (the "non-accelerating inflation rate of unemployment," or NAIRU) is a moving target. As the chart on the left demonstrates, wages did begin to rise in the late 1960s when unemployment fell below 4%, and in the 70s when it fell below 7%; perhaps we just haven't hit the point where employers are getting desperate enough to begin pushing up wages.

There are alternative explanations for why the Phillips curve isn't kicking in, including the idea that in the current market, there is a measurement problem which underestimates the available slack in the labor markets, or that there's something structural that has changed workers' demands for higher wages (e.g., expectations of permanently low inflation). The unemployment rate for under-25 year old workers—the age group with the lowest wages—has been falling faster than any other age cohort over recent months, which may be distorting the wage/unemployment relationship, too. These explana-

The Phillips Curve Past...



...and Present



tions tie in with the idea that the Fed's current estimate of NAIRU at 4.7% is too high. If NAIRU is closer to 4%, as it was in the 1960s, the Philips rule would dictate that inflation will begin to rise fairly soon if unemployment keeps dropping.

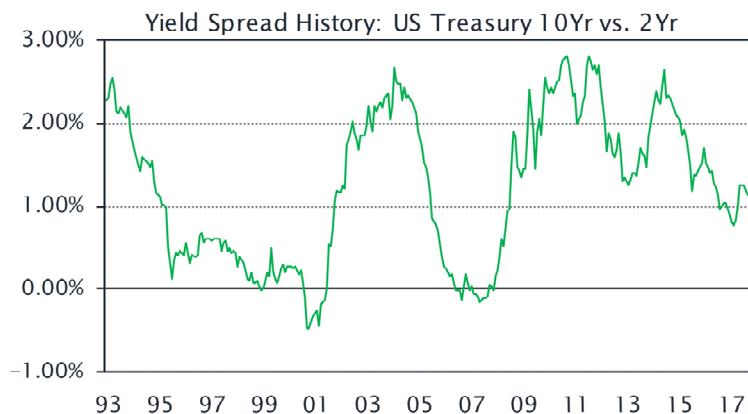
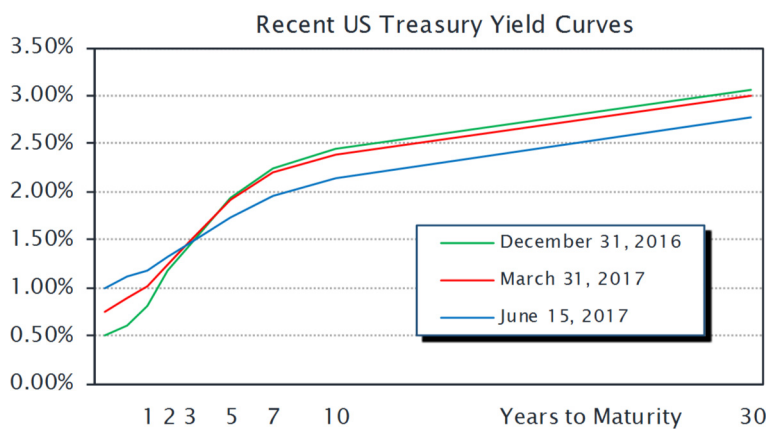
Whatever the explanation might be, the Fed is confident in its NAIRU estimate, and believes that we're already below NAIRU. In the minds of the Fed's policy-making Open Market Committee (FOMC), it's only a matter of time before wage inflation—and by extension, overall consumer prices—begins to rise with a vengeance. And since the FOMC's dual mandate demands that it pursues both "full employment" (job done) and price stability (job done, but they aren't convinced yet), the Fed will continue to push short-term rates up to staunch the inflation that lies in the weeds, just waiting to drag us back to the inflationary era of the late 1970s.

As a result, the Fed has now bumped its overnight borrowing rate three times in the past six months, bringing the current Fed funds target range to 1.00%–1.25%. This, despite the glaring fact that core CPI (now at 1.7%) and core PCE (the Fed's favored inflation measure, now at 1.5%) have been falling in 2017, with the Fed's 2% inflation target moving further away, not closer. The bond market has responded accordingly in 2017, with short rates ratcheting up with each successive funds rate hike while longer-

maturity bonds' yields have been falling (see top chart), as the Treasury yield curve has flattened. Investors clearly view the Fed's tightening action as excessively preemptive and have been emboldened to buy longer-dated bonds at increasingly lower yields.

In addition, there's a real belief among some investors that the Fed's strict adherence to a Phillips curve methodology will result in a policy mistake that has the potential to snuff out economic growth in the name of inflation-fighting. At the very least, additional rate hikes will continue to flatten the yield curve, raising costs for businesses and investors whose borrowing expenses

are tied to short-term rates. As the bottom chart shows, economic cycles typically end with the Fed progressively pushing up short rates until the yield curve inverts, with short rates (e.g., 2-year maturities) eventually exceeding longer rates (e.g., 10-year maturities). Every recession since 1980 has ended with an inverted yield curve (including the 2007–2009 global financial crisis, which occurred after the FOMC raised the funds rate at 17 consecutive meetings). In each instance, yields on 2-year bonds eventually exceeded those of 10-year bonds, as credit became scarce, shutting down economic growth. We've got some distance (80+ basis points) to go before the yield curve inverts in this cycle; it may not happen this time around, but the trend is in place.



Fed Chair Janet Yellen has maintained that the current series of rate hikes is strictly an exercise in policy normalization. Certainly, moving the funds rate up above 1% will make it a more useful tool when the time comes to ease monetary policy. But the risk in this strategy is that the Fed will overshoot, and instead of moving policy towards neutral, they snuff out economic growth by waging a battle that's already won. Later this year, the Fed will take the next step in its monetary policy normalization plan by allowing the bonds in its \$4.5 trillion dollar investment portfolio to begin to mature without being reinvested. The fact that

bond prices have shown little reaction to the release of the details of this plan (the start date of the roll-off is the only piece that's still up in the air) indicates that global investors aren't particularly concerned about having to absorb more than a half-trillion dollars in additional Treasury and mortgage bond supply over the next couple of years.

Only time will tell if the Fed's dogged efforts to root out all inflationary pressures is a case of policy genius or a Quixotic episode of tilting at inflationary windmills. For the time being, it doesn't really matter; the Fed has laid out its plans, and isn't likely to reverse them any time soon.