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The Fed & Rates: Waiting for Job Gains?

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December Disappointment

Despite hopes that November's surprisingly strong employment report would lead to positive job gains by the end of the year, December's payroll data was unexpectedly weak. Payroll employment contracted by another 88,000 jobs, with the unemployment rate remaining steady at 10% only because fewer people were looking for work.[i] As of the end of 2009, businesses remained reluctant to rehire, despite general stabilization in the economic environment and improved corporate profitability. Small businesses, a traditional engine of job creation, continued to face daunting headwinds including limited access to capital and an uncertain sales outlook.

However, the report confirmed the underlying trend of improvement in the labor markets that has been building for months, with leading indicators of employment, such as falling jobless claims and rising temporary worker employment, pointing to a stabilizing job market. During the fourth quarter of 2009, average monthly payroll job losses fell to only 69,000, their lowest rate since the job market deteriorated in early 2008. So while signs of robust hiring have yet to materialize, the overall trends remained encouraging.

KEY TAKEAWAYS

- **Historical patterns demonstrate that the Federal Reserve has typically waited to raise interest rates until after the unemployment rate has declined significantly, which on average has been more than a year after a recession has ended.**
- **December's disappointing employment report did not interrupt the trend of stabilizing labor markets, but future reports of better-than-expected job gains may be necessary to move the Fed to tighten interest rates any sooner than expected.**

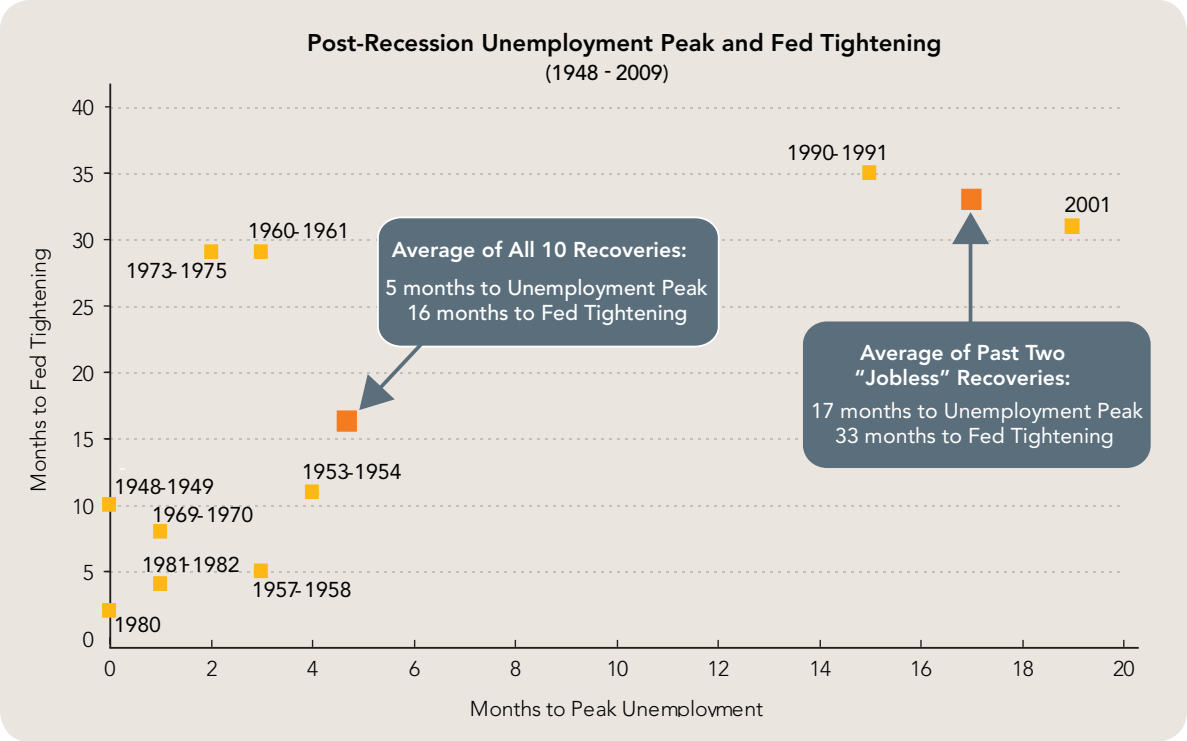
Unemployment: Post-Recession Peaks

Because employment generally lags the direction of the broader economy, during the past 10 post-World War II economic cycles, unemployment never stopped rising before the end of a recession. On average for the 10 cycles, unemployment did not peak until more than four months after the recession ended (see Exhibit 1). However, there was a huge disparity between the first eight recessions that occurred between 1948 and 1982, and the past two (most recent) recessions in 1990-91 and 2001. The unemployment rate peaked relatively quickly after the first eight recessions, on average about a month-and-a-half after the recession ended, with no peak occurring later than four months post-recession. However, during the past two "jobless recoveries," the unemployment rate continued to rise for 17 months (on average) after the recession, representing dramatically longer periods for the labor markets to stabilize.

Unemployment, the Fed and Policy Rates

The pace of labor market improvement is important to the financial markets because it historically has appeared to have some influence on when the Federal Open Market Committee (Federal Reserve) decided to raise its benchmark short-term interest rate. Since World War II, the Fed has never raised rates after a recession until unemployment had already begun to decline, waiting to tighten monetary policy an average of more than 11 months after the peak in the unemployment rate (and after it had fallen more than one percentage point). When factoring in the lag between the end of recession and the eventual peak in the unemployment rate, the Fed on average waited more than 16 months after recession ends to raise interest rates (Exhibit 1). During the two recent jobless recoveries, the Fed was on hold for nearly twice that average—for more than 30 months each time.

EXHIBIT 1: Historically, unemployment has continued to rise for nearly five months (on average) after a recession has ended, and it's taken the Federal Reserve about another year (on average) before starting to raise policy rates.



Tightening refers to raising official policy benchmark rate. Federal funds rate used from 1982-2009, discount rate at Federal Reserve Bank of New York used from 1948-1982. Source: Federal Reserve Board, Bureau of Labor Statistics, National Bureau of Economic Research, Haver Analytics, FMRCo (MARE) as of 12/31/09.

We do not yet know the official date of the 2007-2009 recession end, though GDP data indicates it took place as early as July. We also don't know whether October's 10.2% unemployment rate will prove to be the peak for the cycle. If these dates end up holding, October's peak unemployment rate would have occurred only three months after the end of the recession, which resembles the pattern of earlier recoveries more than the past two jobless recoveries. If the nearly 12-month average for post-recession tightening held, that would have the Fed tightening in mid-2010, roughly where current market expectations point today. Anything closer to higher unemployment and a more sluggish labor market recovery of the jobless variety would presumably pressure this date out further.

Therefore, for the Fed to tighten any time soon, history suggests future employment reports will likely need a succession of several months of additional pleasant surprises.

Investment Implications

Low interest rates around the world and abundant liquidity provided a boost to asset prices worldwide in 2009 (see MARE article, "Ample Global Liquidity Helps Lift Asset Prices"), and any expectation that the Fed will raise rates sooner than anticipated would likely alter perceptions of the market environment. With the Fed's target policy rate near 0%, it is possible this tightening cycle will not move in lockstep with historical patterns, as non-employment considerations such as carry trades, potential overseas asset bubbles and dollar weakness may all prompt the Fed to end its extraordinarily easy policy sooner than its historical average. However, the Fed's traditional attention to employment markets is probably not a thing of the past. The Fed has emphasized in recent policy statements that low rates of resource utilization are a reason to keep rates low, and the Fed still possesses a legislated goal of providing full employment (in addition to price stability). Therefore, for the Fed to tighten any time soon, history suggests future employment reports will likely need a succession of several months of pleasant surprises.

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[i] Source of unemployment rate data: Bureau of Labor Statistics, Haver Analytics, FMRCo (MARE) as of 12/31/09. Individuals that willfully exit the labor force—due to becoming discouraged with finding a job, going back to school, or other reasons—are not counted in the unemployment rate.

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