Data Dependence – Like a Cat Chasing its Tail?

June 21, 2016

Just a few weeks ago Federal Reserve policymakers talked up the possibility of a June/July rate hike, assuming economic data for the second quarter rebounded from a disappointing first quarter performance.

Indeed, the US economy appears to have grown by between 2 and 3% at an annual rate during the current quarter up from 1% in Q1 (though we won't know the official estimate until late July).

Yet the FOMC punted on a hike at the June meeting. In the aftermath, some commentators and many investors have gone so far as to proclaim the "rate hiking cycle is over." The market-implied probability of a rate hike in 2016 plunged and US Treasury yields (e.g., 2-year Treasury note yields) fell to their lowest levels in a year. Use of the "R" word (recession) returned to polite conversation.

So what changed? In a word: payrolls.

That is, the change in nonfarm payroll employment as tabulated by the Bureau of Labor Statistics. Since policymakers talked up the idea of a summer hike, the May nonfarm payroll report (released June 8th) disappointed all expectations, registering just 38,000 jobs added during the month. Many investors and some policymakers worried that the report was a harbinger of slower economic growth to come. Does the jobs number alter our view of the economy and the Fed? Not yet. As forecasters, we know that focusing too much on the jobs number distracts from a host of other healthy indicators.

First, layoffs are lower now than any time in the last 40 years. As measured by initial claims for unemployment insurance, layoffs have been below the 300,000 threshold for 67 consecutive weeks--the longest stretch since the early 1970s.

Second, job openings reached an all-time record high in April, with employers looking to fill 5.5 million positions. Another way to think of it: there are now 1.4 unemployed workers for every job opening available, down from nearly 7 in 2009. In fact, you have to go back to 2001 to find so few unemployed persons to jobs available.

Third, compensation growth continues to accelerate, suggesting that with lots of job openings unfilled and so few layoffs, employers are bidding up the price of labor at long last. Fed Chair Janet Yellen admitted as much during her semiannual congressional testimony, noting "some tentative signs that wage growth may finally be picking up." One of our favorite compensation gauges now shows hourly compensation rose 3.5% versus a year ago--its best rate in nearly a decade.

So, just as the market overreacts to the May employment report, we are seeing the fewest layoffs in a generation, employers are seeking out relatively scarce labor, bidding up employee compensation at a rising rate. And this leads us to our main point (at long last): investors and policymakers that are highly dependent on the monthly change in nonfarm payrolls might find themselves in a situation very similar to my cat chasing its tale.

There is no such thing as data dependence. All data are subject to interpretation. Interpretation of the data in real-time, when the data is subject to heavy revisions, is even more of a challenge.

Our interpretation is that the labor market remains healthy, that the US economy will continue to grow at between 2 and 2.5% through the balance of the year, the unemployment rate will fall and inflation will continue to perk up. If we're right, the Fed stays in hiking mode. Investors (at least based on the behavior of Treasury yields) interpret the labor market data as pointing to an imminent slowdown with a sidelined Fed.

We think that if investors are betting on the "R" word interpretation, they are far too confident in that view.

That said, our confidence in our interpretation of the economy does not lend itself to easy predictions about changes to monetary policy in the months ahead. With 4 FOMC meetings left to go this year, we have to admit the risks are skewed toward one or even zero rate hikes in 2016 not the 2 moves that we currently prescribe. In the Fed's infamous "dot plot," nine policymakers expect two rate hikes in 2016 while six policymakers see just 1 hike for the year (we assume one of those is Chair Yellen). Even if June nonfarm payroll employment (released July 8) shows a bounce, the Committee may want to see a string of such reports before moving ahead.

There is no better reminder of the perils of data interpretation than from the pen (or keyboard) of Janet Yellen just last week: "Unfortunately, all economic projections are certain to turn out to be inaccurate in some respects, and possibly significantly so."

For us, the lesson is: avoid dogma and do not focus too much on one payroll report to shape your view. Or else you risk chasing your tail.