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Unemployment, Inflation, and the Federal Reserve

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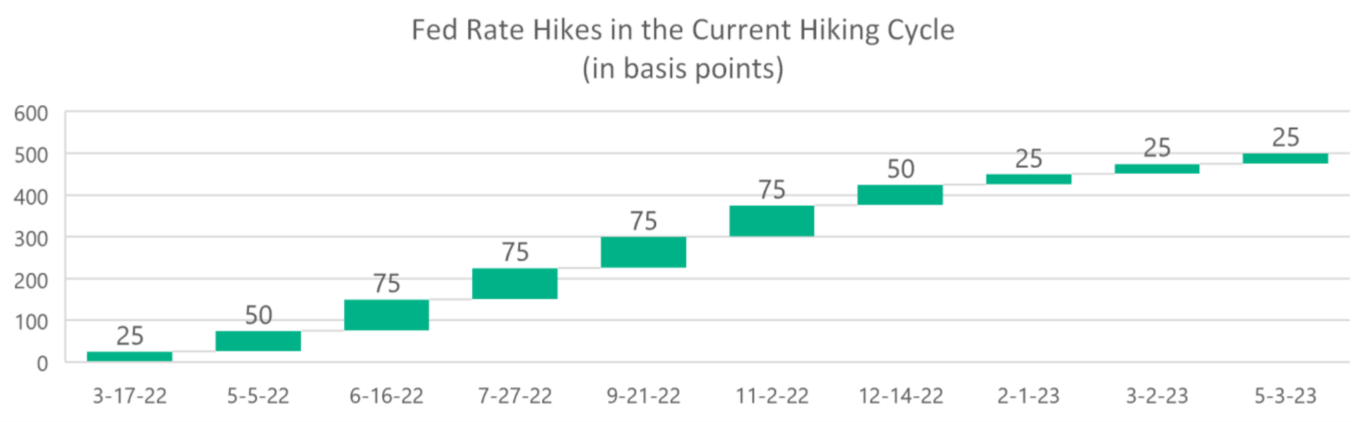
Unemployment, Inflation, and the Federal Reserve

The current environment surrounding the financial markets is fraught with questions. Many revolve around the debt ceiling, the high probability of a recession, the effects of the turmoil in the banking system, and the actions of the Federal Reserve. This last point is something that has been heatedly debated by investors and the media alike.
The Federal Reserve has two principal mandates: Achieving maximum employment and maintaining price stability. In other words, achieving a balance between unemployment and inflation. However, achieving this balance is proving tricky this cycle, as unemployment remains stubbornly low, and inflation stubbornly high.

Looking at unemployment, the weekly Initial Jobless Claims number reported yesterday showed approximately 242,000 new applicants for unemployment benefits, almost 20,000 less than the previous week and nearly 10,000 less than the consensus estimates of 254,000. Continuous Unemployment Claims, or the number of people that have been looking for jobs for several weeks, also came in lower than expected, reported at 1.799 million versus the expected 1.82 million. What this means is that, as of now, fewer people are losing their jobs than previously expected, and those that do can find new employment fairly quickly. In fact, it is estimated that there are approximately 1.6 jobs available for every person looking for employment. Granted, this number fell from approximately 2 jobs available per unemployed person last year, but it is still above the historical average of 1-1.2 jobs, a level that has been concurrent with manageable inflation. With the unemployment rate at a 50-year low of 3.4%, it is hard to argue against the premise that the labor market remains tight.

On the other side of the Fed's dual-mandate, inflation is proving to be stickier than initially expected. Inflation is traditionally measured by the Consumer Price Index or CPI. However, the Fed tends to focus on Core CPI, which removes volatile sectors like food and energy from its calculations. As of last month, inflation, as measured by the CPI, stood at 4.9% on a year-over-year basis. This number has come down from the 8% level seen in 2022, but to give you a frame of reference, CPI has averaged 2.5% over the last decade. Removing last year's abnormally high number from the calculation, the metric's average drops to under 2%. Core CPI has not moved much from April of last year, when it stood at 6.1%, to its current level of 5.5%. Another inflation metric followed by the Fed is the Personal Consumption Expenditures Index or PCE, which measures the prices of goods and services purchased by consumers. Core PCE, which excludes traditionally volatile food and energy, has remained largely unchanged since the beginning of this year, standing at 4.6% as of its last measurement in March. As we can see, although inflation in general appears to be moving in the right direction, it is doing so in a stubbornly slow fashion.

The question plaguing the markets at this point is: What will the Fed do next regarding its dual mandate? Jerome Powell has stated that fighting inflation remains the primary concern. As we know, the Fed has raised interest rates 10 times, by a total of 500 basis points, since March of 2022 to try to counter inflation. As we can see on the following chart, the pace of rate hikes kicked into high gear in the back half of last year but has slowed since. Speculation now abounds on whether the Fed will pause its rate increase at its next meeting in June and begin cutting rates later this year. The data show that markets are expecting a pause at the next meeting and pricing in cuts later this year. However, the Fed is pushing back, saying that although it expects a reduction in rates in 2024 in the range of 75 to 100 basis points, it will not cut this year. In fact, it has not removed the probability of another rate increase at its next meeting.We are even seeing some dissent among Fed governors,



Source: Forbes, Insigneo. As of 5/18/23 as 3 of the 7 governors are leaning towards pausing, yet the remaining 4 are largely undecided. Powell himself has said that he does not want to stop too soon if inflation remains sticky, stating that it is too premature to make that decision, and that this will remain data dependent.

Our view is that the Fed will most likely pause at its next meeting, and unlike the general market, we believe that the Fed will not cut rates until 2024 unless economic conditions take a meaningful turn for the worse. This view is shared by Richard Clarida, Pimco's Global Economic Advisor and former vice-chair of the Federal Reserve, as well as others in the industry. Needless to say, our view is subject to change if we see the data decisively pointing in a different direction, and we will keep you informed with any updates or changes.

It is one thing if the Fed cuts rates because inflation comes down while employment remains relatively stable, akin to threading the needle with a soft landing. It is another thing if the Fed cuts rates because things are unraveling in the economy and the Fed wants to avert further damage, a hard landing. The first scenario would be good for the markets, but given the reasonable possibility of the second scenario, we feel it is better to be prudent and position ourselves to protect profits and take some chips off the table.

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