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The Fed is out of excuses

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- The Fed's most watched indicators suggest that monetary policy is not restrictive enough. Payroll employment growth remains strong with monthly growth normalizing to the pre-pandemic average, vacancies in relation to unemployment has only gently fallen, and growth in the PCE deflator is moving sideways. Additionally, monetary policy is at odds with fiscal policy in certain sectors, which likely means that the terminal rate needs to be higher to reach a sufficiently restrictive level. More rate hikes are likely in this tightening cycle.

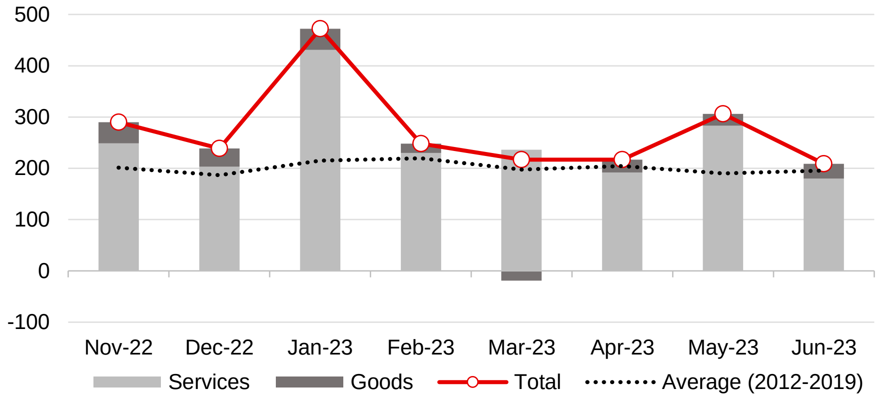
Normalizing in the labor market

The labor market added 209,000 jobs in June, slightly below expectations. However, at this point, actual growth in relation to forecasted expectations is meaningless in determining the trajectory of the economy. Operating under the Fed's assumption that a tight labor market contributes to inflation, there is little indication that the labor market has "cooled" enough for inflation to drop down to 2% anytime soon.

Employment growth has been robust for both goods and services industries in 2023, with March being the exception for goods. These monthly dynamics are similar to the years before the pandemic (2012-2019) where services industries were consistently positive and goods industries had intermittent months of negative growth, though they were generally positive. The labor market has "normalized" in this regard, but it has taken interest rates risings at a historically fast pace to reach this level. It is hard to imagine inflation falling meaningfully under these conditions.

Though the labor market in 2023 has cooled in relation to 2021 and 2022, there is no indication that this broad slowdown will continue with the lower bound of interest rates remaining at 5%. Construction is one of the most interest rate sensitive industries, but employment growth has been consistently positive (adding 23,000 jobs in June) despite average mortgage rates rising to near 7%. This can largely be explained by severe residential housing shortages and a need for more construction spending in this sector (already around 45% of total construction spending). But fiscal policy is also supporting spending and subsequently employment in this sector.

Jobs growth has "normailzed" to the pre-pandemic average
Nonfarm payroll employment growth, thousands



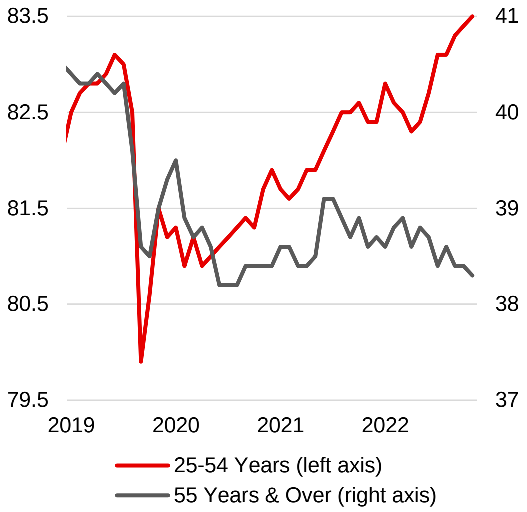
Source: BLS, MUFG Bank Economic Research

Subsidies to support the re-shoring of semiconductor manufacturing have helped prop up employment in construction, with the share of construction spending in manufacturing increasing from 6.5% to 10% since the Chips and Science Act was passed into law in late July 2022. If bringing inflation down to 2% requires cooling labor demand, then monetary policy must be more restrictive to offset the stimulatory effects of fiscal policy.

For other industries, growth has moderated a bit in June, particularly in professional and business services and leisure and hospitality. Other industries including retail trade and transportation were largely unchanged. But this shouldn't necessarily be interpreted as having a sufficiently restrictive monetary policy, especially in industries whose employment has exceed their pre-pandemic level.

Older workers are not rejoining

Labor force participation rates, %

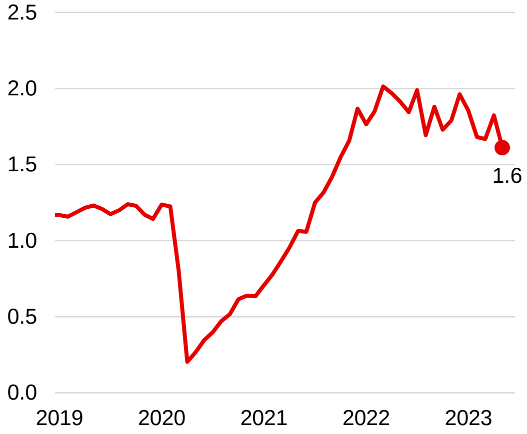


Source: BLS, MUFG Bank Economic Research

Jobs can only be added if there are workers to fill them. Older workers (55 and older) represent nearly a quarter of the civilian labor force, but the labor force participation rate is still well below what it was before the pandemic, and it continues to gradually fall. This has been partially offset by prime-age workers (25-54 years old), whose participation rate has exceeded their pre-pandemic rate, but not by enough to fully account for historically high labor demand.

Labor demand still exceeds supply

Vacacy to unemployed ratio



Source: BLS, MUFG Bank Economic Research

The vacancy to unemployed ratio fell in May to 1.6, but this still indicates a strong imbalance of labor supply and demand. Modestly improving participation rates for prime-age workers can't fully account for this significant mismatch. Additionally, both hiring and quits accelerated in May. It would be overly ambitious to be certain about interest rate policy because monthly employment growth now looks historically "normal," while at the same time labor demand and turnover looks historically "abnormal."

To add to the uncertainty, false signals have been appearing nearly every month, only to be reversed in the months after. There could be distortions in seasonal factors since the pandemic that cause volatility in monthly data along with inaccurate accounting of jobs being added or lost from new/dead firms. All of this combined with normal volatility in monthly data means that one should be careful about being overly optimistic. The Fed will likely take maintain their view that there needs to be clearer evidence that the labor market is indeed cooling. More rate hike appears inevitable.

Inflation is moving sideways

The Fed's preferred inflation measure, the PCE Price Index or PCE deflator, is showing stubbornly high price growth. Core PCE, excluding food and energy, is running at 4.6%

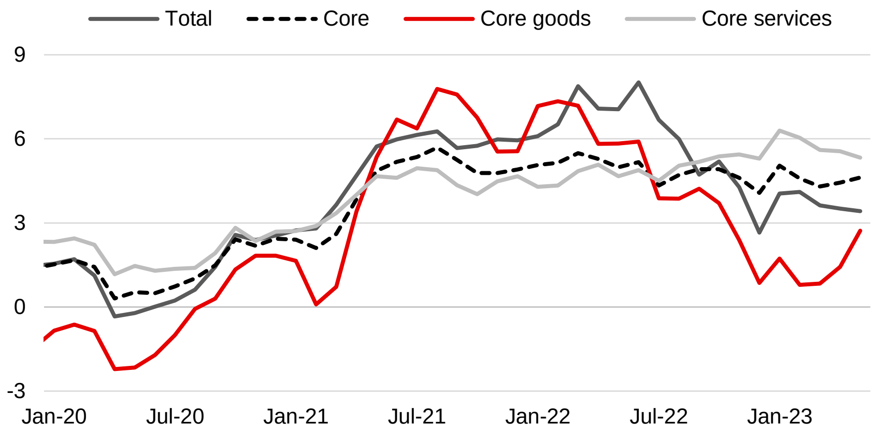
on a 6-month annualized growth basis, virtually unchanged over the past 10 months. This is contrary to the CPI, where price growth is exhibiting much stronger disinflation.

The differences stem from methodology, but in this case, the PCE deflator appears to be representation of the overall economy. For housing, inflation in both the CPI and PCE expectedly lag private sector measures since they intend to capture the consumption portion of housing rather than the investment aspect.

For example, the S&P Case-Shiller Home Price Index reflects the investment portion of home ownership. Annual growth in this index has been declining since April 2022, and reaching negative growth in April 2023. This lag has yet to materialize in the CPI where growth in housing continues to accelerate. However, the PCE deflator is beginning to reflect the lag, showing housing disinflation at a 6-month growth annualized basis (8.1% in April vs 7.7% in May). This has prevented core services from accelerating, but growth remains high at 5.3%.

Core goods prices accelerated in May

PCE Price Index, 6-month growth rate, % annualized



Source: BEA, MUFG Bank Economic Research

Core goods will be an important subset of inflation to watch in the coming months. Historically, keeping overall inflation around 2% has meant that certain spending categories had to be deflationary. In the decades before the pandemic, core goods have usually taken this role. Today, the hopes that core goods will have negative price growth are dissipating. Used autos have been the leading cause of re-accelerating core goods prices, and fears of a price-price spiral may emerge in goods.

Used autos can be considered an outlier in this scenario since the pandemic heavily distorted new car production, subsequently reducing the supply of used cars. Price growth here has largely been a supply-side issue. Inflation expectations, however, can spread to other goods in a price-price phenomenon where price growth in certain items increase inflation expectations which in turn lead to consumption and price growth in other items. Real consumption of durable goods remains high, but it is not accelerating, so the risks are still low. Additionally, overall inflation expectations remain anchored.

The risks of re-accelerating inflation are low, but disinflation is also not occurring. The strong labor market and the sideways moving PCE deflator will likely have the Fed raising rates in the next FOMC meeting.

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