FVCM

U.S. MARKET REPORT

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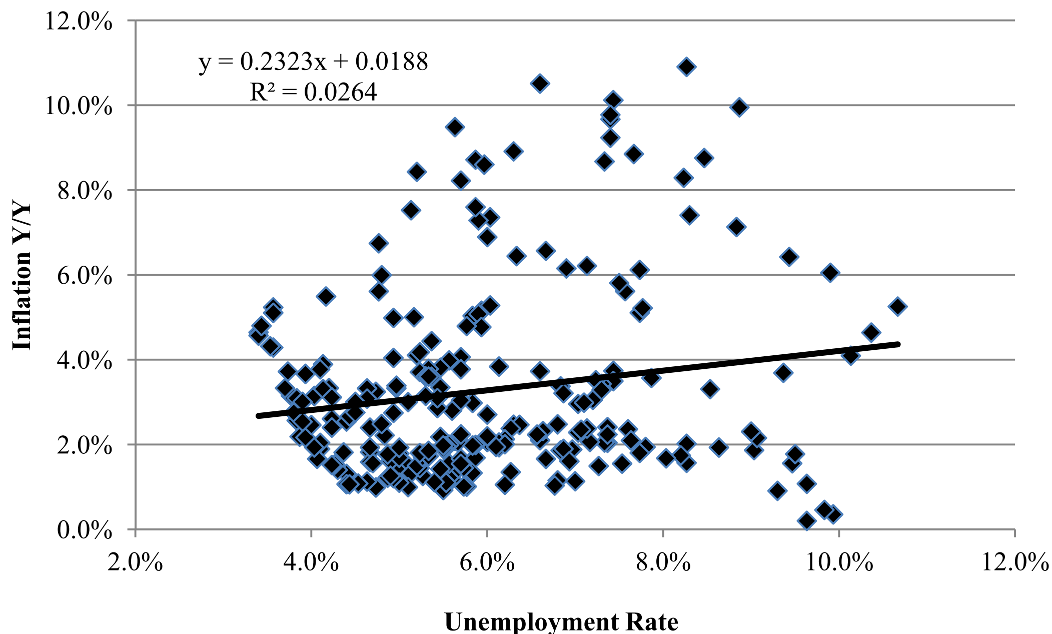
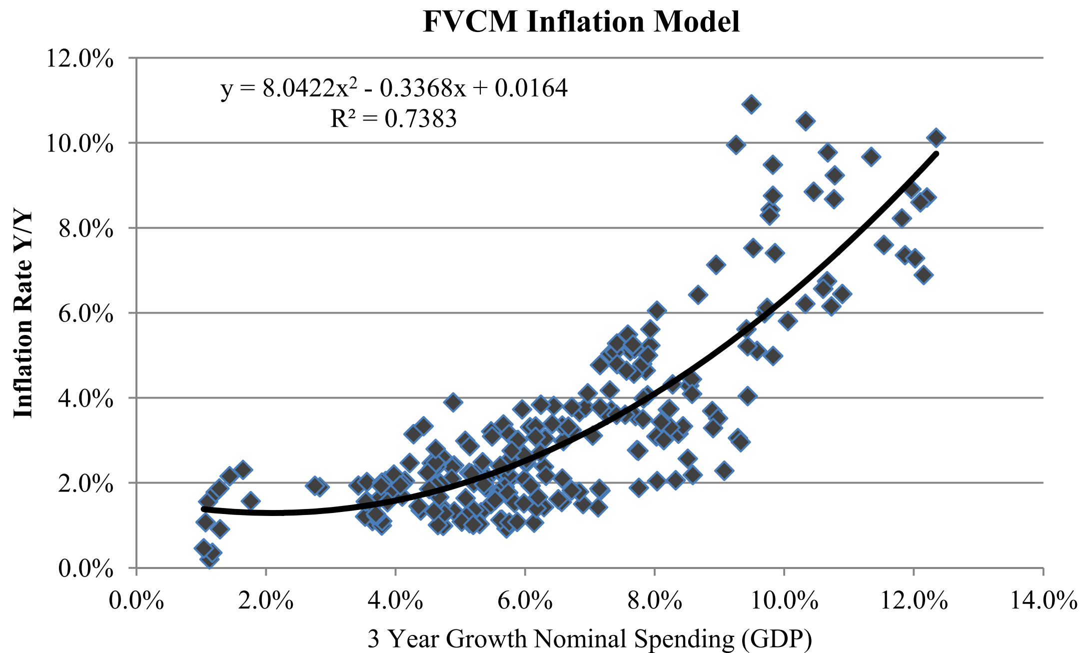
The Fed Focus on Unemployment Misguided

A page 2 story in the Wall Street Journal (Inflation Riddle Complicates Rate Policy, July 20, 2017) again pointed out Fed Chairman Janet Yellen's and the Fed's odd focus on the so-called Phillips Curve, a theoretically inverse relationship between unemployment and inflation. When unemployment is low, inflationary pressures are supposed to be rising. The Fed's use of the Phillips Curve is odd because many of us remember unemployment rising steadily during the 1970s at the same time that the inflation rate increased. We also remember the long stretch in the 1980s when inflation and unemployment both declined precipitously. Moreover, when looking at more than fifty years of quarterly data, the unemployment rate seems to "explain" only 2.6% of the concurrent inflation rate. Even more oddly, a regression line in the data is positively sloped, meaning that low unemployment correlates with low inflation and vice versa, the exact opposite of what the Phillips Curve suggests. But, doesn't this make a different kind of common sense? More people working means more goods and services available to purchase for whatever dollars people want to spend.



There is an alternative to consider. Isn't inflation really a function of spending? Consider that while the Fed managed a 6.0% increase in the money supply over the past three years, spending (nominal GDP) has grown at only a 3.8% rate because people have been content to accumulate money balances—something the economists call hoarding. If we put a curve through the data, where inflation is dependent on

spending over the past three years, we get a good fit of 73.8%. What is that model telling us? That inflation is grounded at about a 1.5% rate because in recent years people just haven't been in a spending mood. That being the case, the Fed shouldn't be so worried about people getting jobs. They have time to react and dampen spending growth when and if it starts to exceed 4%, or about what we've been experiencing.



Our conclusion is this: If inflation persists in the 1%-to-2% range, as we expect, the Fed will dial back its plans to raise short term interest rates and shrink its balance sheet. Equities will continue to benefit from high valuations, thanks to the low inflation, and stock prices should continue to trend higher with earnings growth. The biggest risk to equity prices could be the Fed, and we think they will see the light.

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