The Federal Reserve's slow approach to raising rates

Hilliard MacBeth

Hilliard's Weekend Notebook – Friday December 15, 2017

OUR PARTNERS

The MacBeth Group

Richardson GMP
10180 101 Street, Suite 3360
Edmonton, AB T5J 3S4

Tel. 1.780.409.7735
Fax 780.409.7777
www.TheMacBethGroup.com

Hilliard MacBeth
Director, Wealth Management
Portfolio Manager
Tel. 780.409.7740

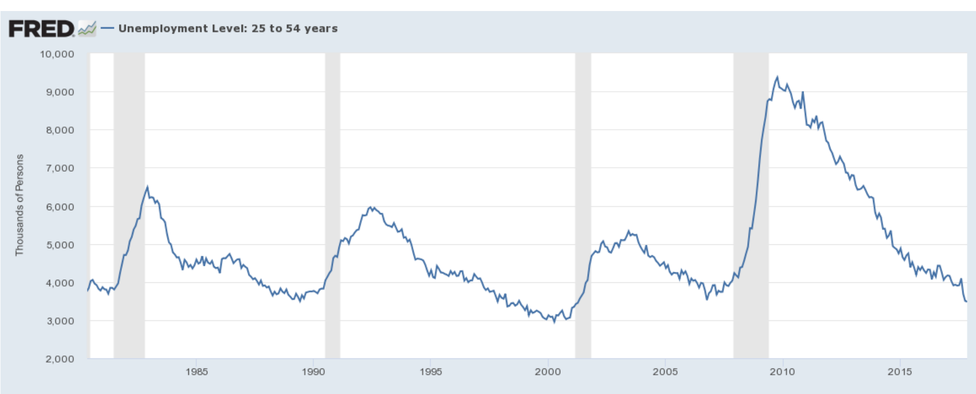
This week the Federal Reserve announced another small increase in the Fed Funds rate. This latest increase is the third this year, and the fifth since late 2015 when this round of monetary policy tightening started. The Fed Funds rate is still low by historical standards.

Will there be more rate increases in 2018? Why is the Fed moving so slowly in this cycle?

The Federal Reserve hiked the Fed Funds rate by 0.25 percent. No one on Wall Street was surprised, as the Fed had hinted at the move and news on the U.S. economy has been consistently positive. Some have wondered why the Fed has not raised rates more aggressively given the unemployment rate at 4.1 percent, a level that used to be considered "full employment". Unemployment is one of the Fed's most important indicators.

Part of the Fed's job is to provide stimulus when needed and to withdraw excess stimulus when it is no longer appropriate. Moving interest rates higher and lower is one of their most powerful tools.

One measure of employment is very positive. The number of unemployed people in the key working age category is close to all-time lows, even compared to decades ago when the total population was much larger. Here's unemployment in the key working age group of 25-54 years:

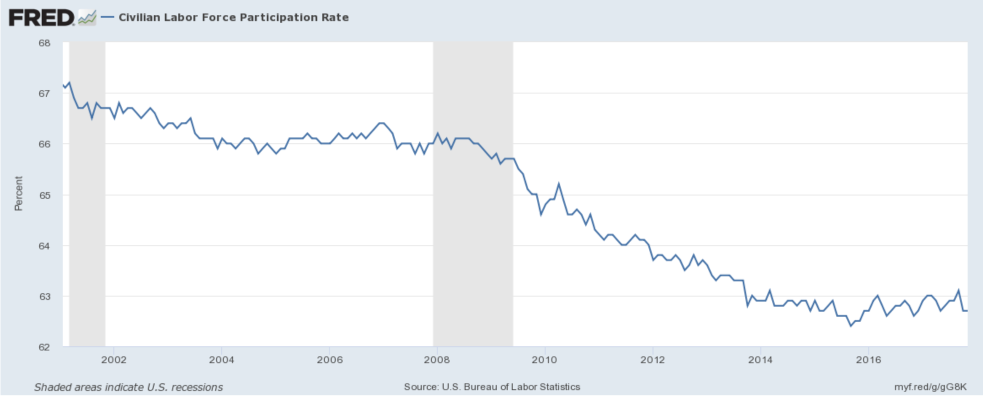


Source: FRED/St. Louis Fed

Only one time in the last four decades, in 1999, was the number of people out of work — 3,000,000 — smaller than today. This is very positive news. So why is the Fed taking such a slow approach to normalizing rates?

The Fed's policy stance is contingent on a number of things, like inflation, employment and growth. But there is one indicator that is flashing a "slow down" signal.

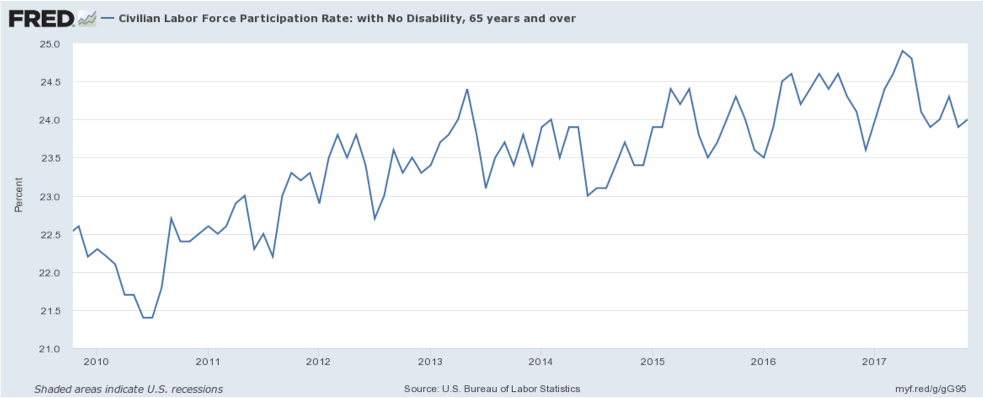
The labor force participation rate started dropping during last recession, in 08-09, and has continued to decline for more than 7 years:



Source: FRED/St. Louis Fed

From an all-time peak of 67.3 percent in 2001 this measure of employed people dropped by four points and is bouncing around a long-term low of 63 percent today. It seems impervious to the Fed stimulus provided during the decade-long recovery. That drop represents more than 6 million people who've left the labor force.

Some pundits have opined that the low participation rate shows baby boomers are leaving the work force. But that is not the case, at least not when looking at the 65+ rate group.



Source: FRED/St. Louis Fed

As we saw above, the raw number of unemployed people is near rock bottom. In another era the Fed would be hiking rates very aggressively by now, especially in the ninth year of recovery.

But these are not normal times.

The media release by the Fed says that the Open Market Committee is planning more rate hikes in 2018. Most observers expect three hikes, while some expect even more. At the current slow pace of 0.25 percent for each raise, the Fed Funds rate would be at 2.25 to 2.50 percent by the end of 2018. That level would still be unusually low at this point in a recovery, by the standards of past economic expansions.

But unless unemployment measures like the participation rate improve dramatically the Fed is likely to continue to go slowly.

On the other hand, if the participation were to move back to 67 percent or inflation were to jump higher than 2 percent and the unemployment rate were to fall below 4 percent the Fed would be forced to start raising rates at a much faster pace.

But, for now, there are just too many people sitting on the sidelines, not working and not benefitting from this unusual recovery.

Hilliard MacBeth