US Macroeconomics

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What Will It Take for the Fed to Cut?

There are only two criteria in our view. One, **the unemployment rate needs to rise** at least a couple of tenths to 3.9%, as this would reestablish the recession tripwire that was briefly hit last year before revisions. Two, **there must be more progress made in reducing the rate of core inflation**. This means we need to see renewed slowing in core inflation as measured by the three-, six- and 12-month annualized growth rates. Unfortunately, the December consumer prices reports showed a halting in inflation progress.

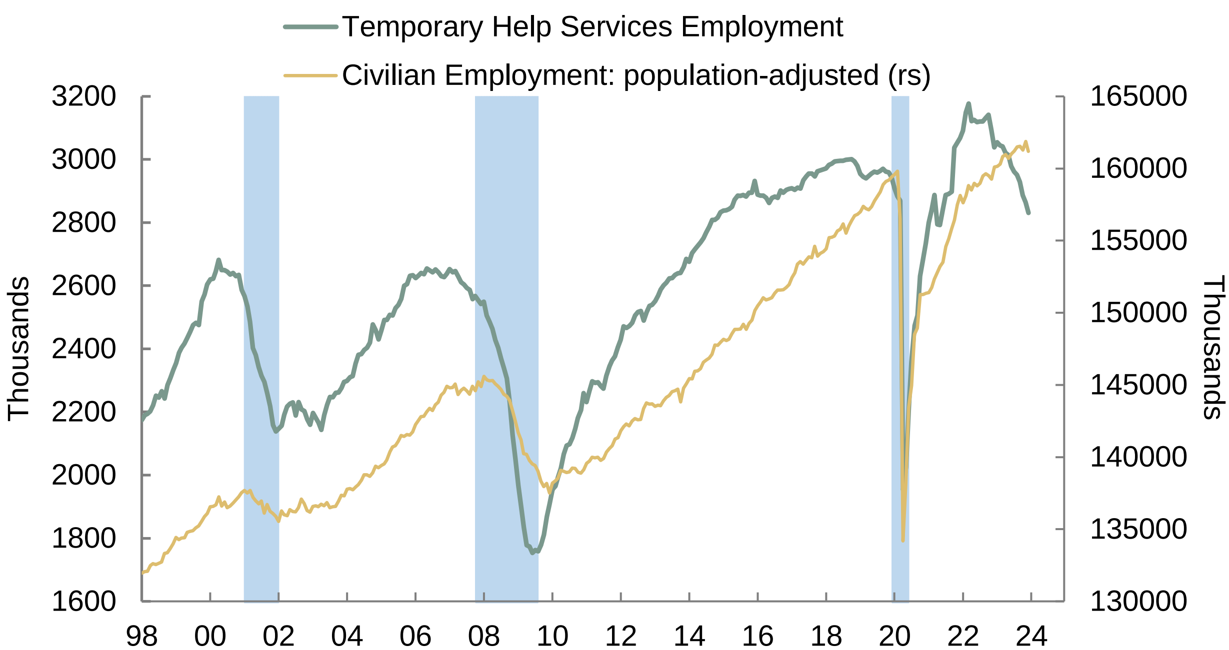
So how likely is it that unemployment will rise, and inflation will slow? It is likely in our view, which is probably why the futures market is still assigning roughly a 60% probability that the Fed cuts rates on March 20th.

The labor market is weaker than the headline numbers suggest. The unemployment rate was steady at 3.7% last month but household employment fell a large 683k and has been down in two of the last three months. If not for a large decline in the labor force participation rate, the unemployment rate would have risen last month.

However, since household employment is likely to remain weak, there is a good chance the unemployment rate edges higher over the next couple of months. For example, **temporary hiring, a gauge of future labor demand, has fallen 11 straight months**. Generally, this does not happen outside recession or a very weak economy.

Regarding inflation, core goods prices were flat last month after declining five months in row. But **the price of imported Chinese goods continues to fall, and the CRB all-spot price index is hovering near a multi-year low**. Therefore, it is just a matter of time before core goods prices soon resume their negative readings.

While stickier, the trend of core services inflation should moderate, too. While they were down a tenth last month to 0.4%, and the 12-month change fell 0.2% to 5.3%, prices are still elevated. Fortunately, services are dominated by housing rents, and more supply is coming online. **Last year saw the most multi-family home completion since 1988**. And this happened just as the nationwide apartment vacancy rate was on the rise.



Source: BLS, Haver, SMBC Nikko

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