

Flash Comment US

Fed's dilemma

Low unemployment and inflation at the same time

In terms of employment growth, the June jobs report was strong, as employment grew 222,000, significantly higher than expected, and April and May were revised up by a total of 47,000. The unemployment rate rose to 4.4% from 4.3%, as labour force growth exceeded employment growth. The increase comes after the unemployment rate has fallen from 4.8% in January so given its volatile nature, it is not a big concern. The Fed's favourite slack indicators, the so-called underemployment rate (U6 unemployment, a broader unemployment measure) rose to 8.6% from 8.4%.

While the jobs reports show the US labour market continues to tighten overall, it also underpins the Fed's dilemma: unemployment and (wage) inflation are low at the same time (the opposite situation of the 1970s). Still the Fed is hiking rates, as Yellen and her colleagues have a strong belief in the Phillips Curve: The tight labour market should be sufficient to push wage growth and inflation higher eventually. In our view, the problem is that the tightness of the labour market is not the only factor determining wage growth, as second-round effects after many years with low inflation have hit wage growth. When employees expect inflation to remain low, they can live with low wage growth, as real wage growth may still be solid, making it less likely inflation will reach target, see also *Strategy: Central banks consider leaving the party*, 30 June.

Due to the Fed's strong faith in the Phillips curve and given we expect further tightening of the labour market, **we think the Fed will make an announcement in September on balance sheet reduction ('quantitative tightening') and hike one more time this year in December**, see also *FOMC minutes: Fed likely to announce start of QT in September*, 5 July. We still think risks are skewed towards the Fed pausing its hiking cycle due to low inflation, which may not be just 'transitory' given the low inflation expectations, see also *FOMC review: Hawkish Yellen ignores inflation and economic data*, 15 June. In that regard it is interesting that four FOMC members indicated that they do not expect the Fed to hike more this year.

Today's key points

FOMC minutes: Fed likely to announce start of QT in September

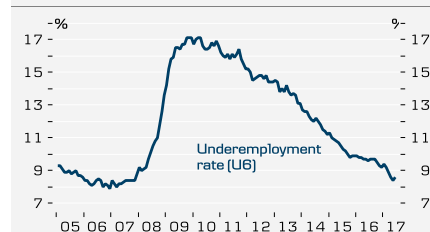
FOMC review: Hawkish Yellen ignores inflation and economic data

Fed's quantitative tightening details: Impact on the balance sheet and reinvestments

Fed's 'Quantitative tightening': Fixed income implications

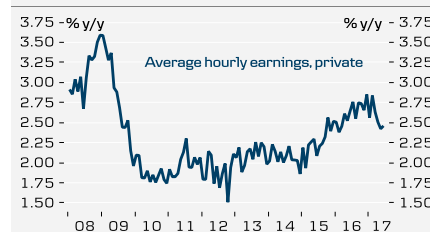
Research US: Fed's regulatory hurdle for starting quantitative tightening

Fed's dilemma: low inflation...



Source: BLS

...and wage growth at the same time

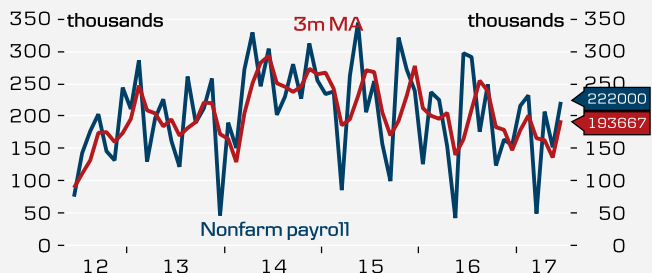


Source: BLS

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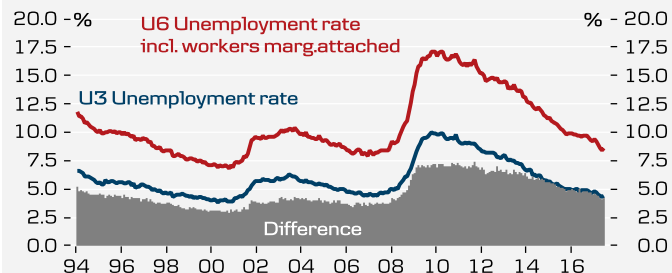
Employment

Solid employment growth in June after some weak reports



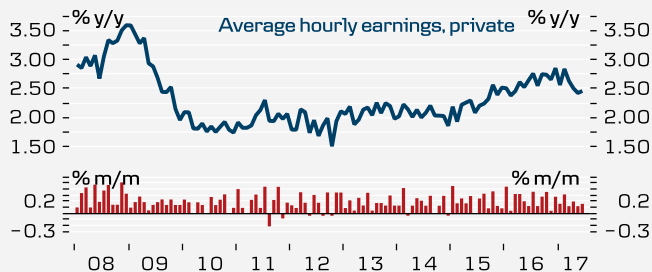
Source: BLS, Danske Bank Markets

Tighter labour market despite marginally higher unemployment rates



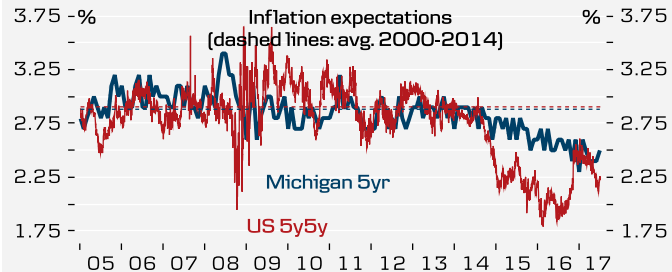
Source: BLS, Danske Bank Markets

Low wage growth a mystery for the Fed



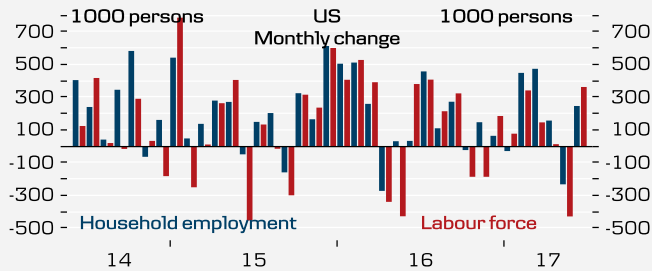
Source: BLS, Danske Bank Markets

Low inflation expectations at least partly to blame



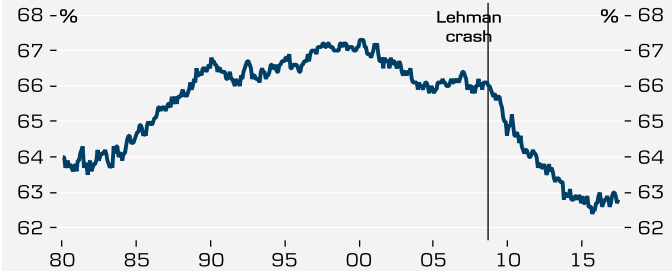
Source: BLS, Danske Bank Markets

Labour force growth exceeded employment growth in June



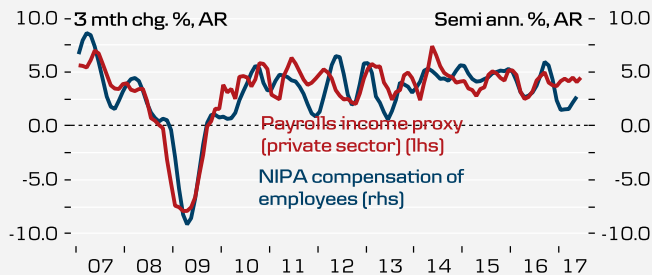
Source: BLS, Danske Bank Markets

Participation rates lower mainly due to demographics



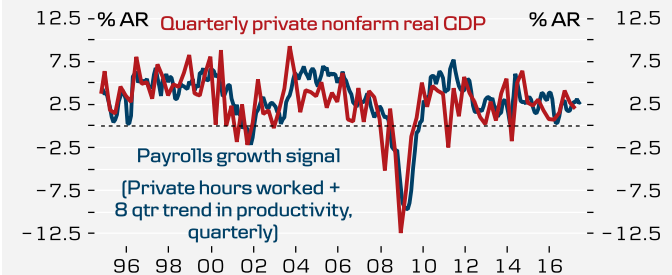
Source: BLS, Danske Bank Markets

Payrolls income proxy



Source: BLS, Danske Bank Markets

Payrolls GDP signal



Source: BLS, Danske Bank Markets

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Expected updates

None.

Date of first publication

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