Normalized Employment And Inflation

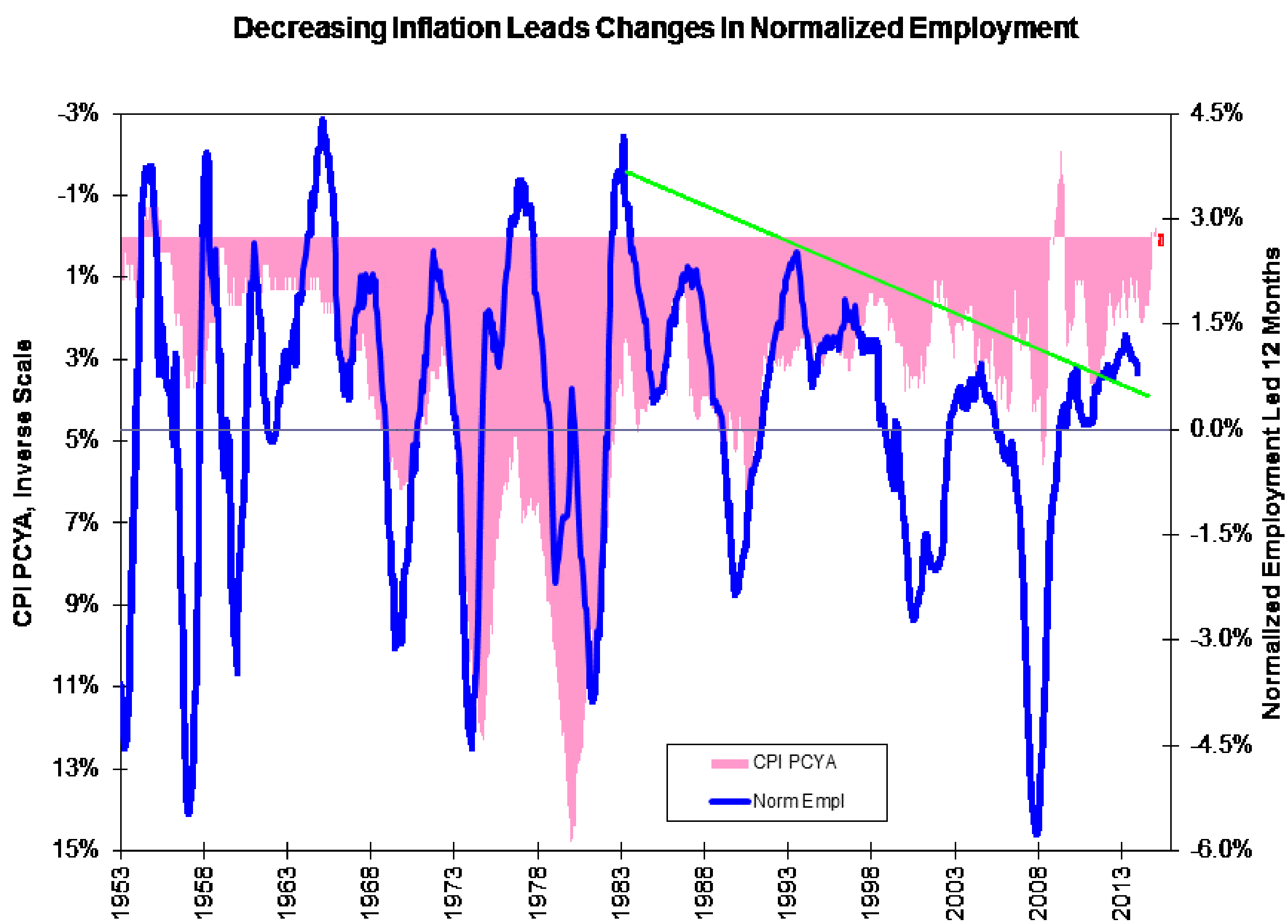
One of life's great mysteries is why both central banks and market participants keep acting as if monetary policy has deterministic outcomes. I noted [recently]() both reported and expected inflation have been immune to the massive expansion of the Federal Reserve's balance sheet since 2008. This has stopped no one from discussing any impending rate hike in terms of an arbitrary target, such as 2% growth in the core PCE indicator.

The same comment holds true for the employment picture. The current consensus is last Friday's employment situation report took a rate hike off the table for the remainder of 2015. While this is probably true, we should remember how many times the consensus has oscillated this year and how much public disagreement amongst FOMC members there has been in recent weeks.

Normalized Employment

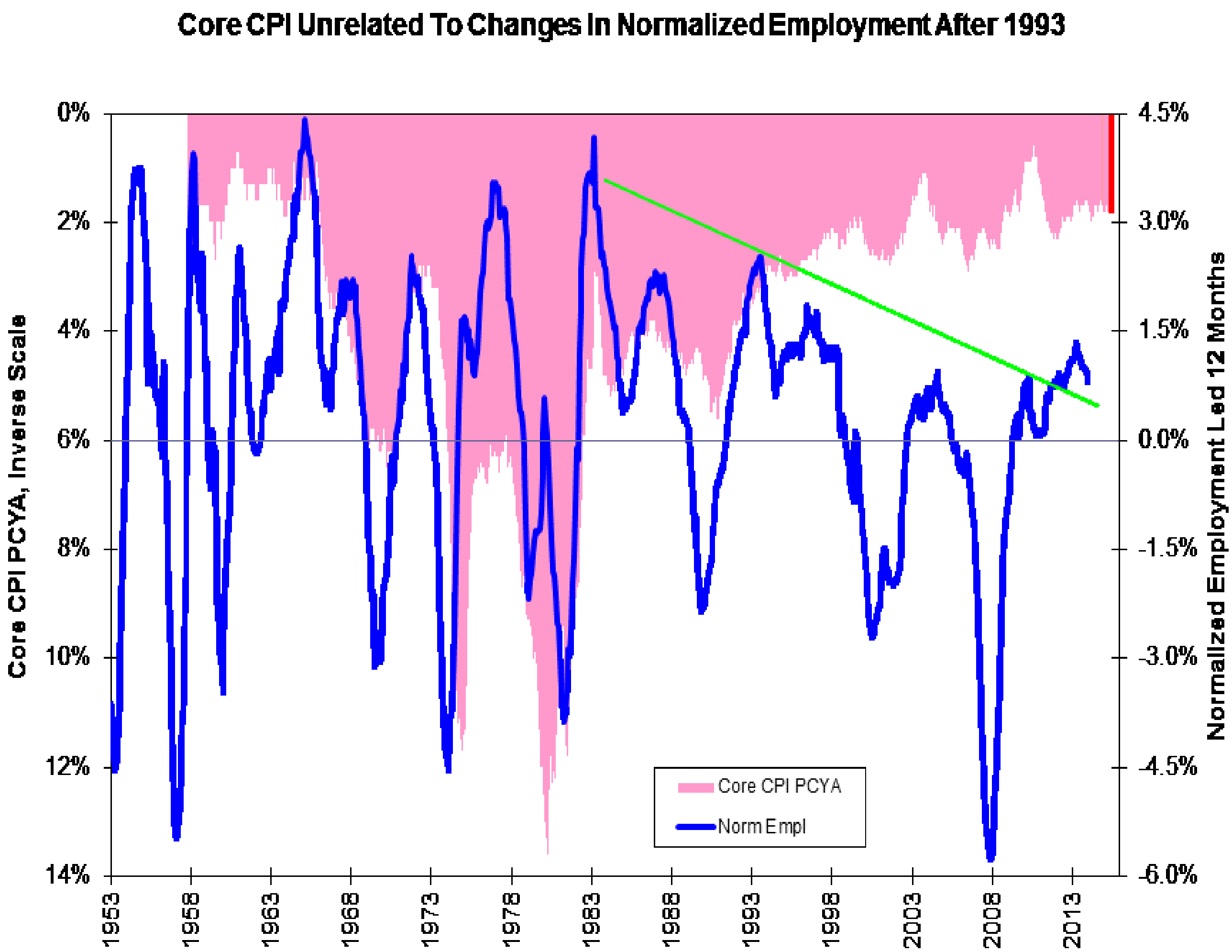
Let's define normalized employment growth is the change in nonfarm payrolls adjusted for changes in the civilian non-institutional population. Year-over-year changes in normalized employment growth broke out of their post-November 1983 downtrend (green trendline) in November 2011 but are retreating back toward that downtrend line now.

Official policy remains focused on increasing the rate of inflation, which is quite odd given the relationship between year-over-year changes in the CPI lagged twelve months and normalized employment growth is a strongly negative one, with a beta of -0.203.



If we shift the measure of inflation from headline to core CPI, the relationship breaks down altogether after 1993. While the beta is positive over this period, 0.26, the r-squared or percentage of variance explained is a near-random 0.0038. Core CPI's PCYA has been declining at an average monthly rate of 0.0001% since December 1993, and yet there is a willful refusal to recognize this as a secular trend and accommodate accordingly.

When normalized employment growth broke out of its secular downtrend in November 2011, core CPI's PCYA was 2.2%. It fell below this level in July 2012 and has yet to match it; the reading for August 2015 was 1.8%. Normalized employment growth demonstrably can increase in a declining consumer price inflation environment regardless of the inflation measure chosen. Moreover, a period of rising CPI changes can lead to declines in normalized employment growth.



We are left with a bit of a mess with monetary policy. We cannot conclude accommodation leads to higher inflation and we cannot conclude the higher inflation level sought will lead to a stronger labor market. About the only thing we can conclude is higher short-term interest rates will lead to a flatter yield curve and, depending on what other countries do, quite possibly a stronger dollar. The risk/reward of raising short-term rates given the uncertainty of what such a move is one most traders would avoid.