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Terrible Payroll Slams Fed Hike; Yellen's Speech Monday Critical

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Like a tornado, it came without warning. There was no rise in jobless claims and the ADP number hit expectations on the nose. But my jaw dropped upon seeing this morning's payrolls race across the screens, for rarely has a payroll report missed expectations by so much. Not only did May payrolls increase a measly 38k versus 160k expectations, but the previous two months were revised downward by an additional 59k and hours worked were revised sharply downward. Furthermore, in face of these wretched payroll numbers the unemployment rate fell by a whopping 3 tenths to a 9-year low and is just 3 tenths above the cyclical low reached during the subprime housing boom of 2006-7. The fall in unemployment was caused by a sharp decrease in the participation rate that has now undone almost half of that oh-so promising participation rate rise that we economists were smiling about over the previous 6 months. These trends do not bode well for an extended economic expansion as the unemployment rate can only drop so low before the Fed must tighten, whether they like it or not..

Of course, the hawks on the FOMC can point to the large fall in the unemployment rate as ammunition to raise rates. But the sharpness of the fall-off in new jobs has to shake most Fed members and embolden the doves to hold off any increase at least until July (in addition by July we will know the Brexit vote). Market reactions to this morning's news followed the textbook response: bond rallied sharply and the dollar fell dramatically. Stocks initially fell by 150 points but recovered as lower yields cushioned the impact of slower economic growth on earnings. The only silver lining in today's report is that productivity growth in Q1 and Q2 is not quite a horrendous as the data suggested, but this is small comfort for those of us who hoped that this business expansion would be extended by a rising participation rate.

This report come very close to the next FOMC meeting which occurs a week from Tuesday and members will have to come to a decision about rates the following Wednesday. This makes Janet Yellen's speech this Monday at the World Affairs Council in Philadelphia (12:30ET) one of the most important non-Congressional speeches that she has ever given. The market has decided she should defer any rate increase. Recall that the rise in stocks last week was predicated on the Fed seeing a strong US economy. Unless Yellen can convince the market that she has information that indicates this morning's report was a total anomaly, any indication that the Fed will go ahead with the rate increase could spark a severe sell-off in equities.
