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Blockbuster Payroll Gains (Almost) Guarantee Fed Rate Hike

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An extremely strong payroll number puts the Fed firmly on target for a rate increase in December. Unemployment ticked down to 5.0% as expected, and U6 declined below 10% to 9.8%. Average hourly earnings were up 0.4% after a zero increase last month. Furthermore the average hourly earnings year over year rose to 2.5%, 2 tenths above expectations and the highest since 2009. The household data were also very strong, recording a 320k increase after a 236k decline last month, while the participation remained unchanged 62.4%.

Stock futures immediately sold off but then recovered to slightly down. The ten year Treasury reached 2.32% and the dollar rallied, with the Euro touching a 7 month low of $1.07, just 3 cents above the low reached earlier this year. I have said that Draghi wants parity for the dollar, and his wish may come true. Fed funds futures are now signaling a 3-1 probability of an increase based on the simple midpoint computation with no risk premium. But, as I indicated last week, the actual chances are likely to be much higher, which I now put well over 80%. Of course, we have more than 5 weeks until the December meeting: one more employment report and several inflation reports. But future data would have to be decidedly negative to prevent the Fed from acting.

The employment report certainly is the most important news this week. But the most surprising data this week was the report on Q3 productivity. It was forecast to be down 0.3% and reported up 1.5%. Normally productivity is very easy to forecast, just subtract the growth in hours, which come from the employment reports, from the GDP growth, which was reported a week ago. Rarely does the forecast miss by more than 2 or three tenths. But the Labor Department reported a massive drop in the hours of the self-employed (which are not reported in the monthly labor reports), seemingly caused by a revision in the methodology of computing such hours Of course, one quarter does not offset all the years of extremely low productivity, but it is heartening to know that productivity growth might be recovering. Of course, a further rise in the dollar will be a challenge for US globally oriented firms. But if a lower Euro strengthens the European economy, the negative dollar impact could easily be offset by stronger European sales.

In summary, stocks will have to fight its way through higher yields, but I think the positive implications of this report for earnings will dominate higher yields in coming weeks. The removal of policy uncertainty is more important for equities than a 25 bp bump in the Fed Funds rate.
