Fed Rate Hike Now Very Likely and Not Yet Factored Into Markets

Friday, 9:20 am EDT

As I said on CNBC yesterday afternoon, watch the unemployment rate and wage gain to get insight into what the Fed will do on September 17. Although the futures market has yet to move significantly, I believe that the probability of a rate hike in 2 weeks has taken a big jump as a result of today's employment report, and now stands at 3 to 1. Yes, the headline payroll gain was below expectations, coming in at 173k, but when added to the upward revisions of 44k for the previous two months, the gain exactly hit the expectations of 217k. But more important is that the unemployment rate hit another cyclical low of 5.1%. That is in the middle of the "frictional" or "natural" range of unemployment which the Fed had indicated is between 5.0% and 5.2%. Below that range, the Fed believes that labor market tightness induces wage increases that outpace productivity, boosting labor costs and subsequently inflation. Indeed, the economy has consistently been generating about 225k jobs a month, about 75k or 30% above the increase in the labor supply due to demographic factors. This reduces the amount of surplus labor that can be absorbed at non-inflationary wage increases. Furthermore, the average workweek increased to 34.6 hours, and was revised upward by 0.1 hours for July. This is approximately a 0.3% increase in hours worked, equivalent to another 300k workers at 34.5 hours. Indeed, hourly wages increased 0.3 ppts, one tenth above expectations. Although the year over year increase is still only 2.2%, wages can be expected to rise further in the coming months. The increase in the number of hours worked, given the increase in GDP, means that productivity is lagging even more than previously reported, putting direct pressure on the labor market. The only events holding the Fed back in two weeks would be a significant further weakening in equity and commodity markets, and I mean by that a further fall of 10% in stocks, and oil dropping into the mid $30s or below. Certainly that cannot be ruled out, but the likelihood is well below 50-50.

The market has not factored a 3 to 1 probability of a Fed rate hike. Stocks won't like it, and neither will bonds or precious metals. But it is far from the end of the world. And, as I have predicted for many months, stocks will likely rise in the fourth quarter once the Fed hike is out of the way. What is far more important than whether the Fed moves in September or December is the pace of the tightening, and the statements by virtually all the FOMC members indicate "go slow." A second December hike is unlikely unless that economy accelerates significantly. I expect a downward cast for the equity market until the September meeting.
