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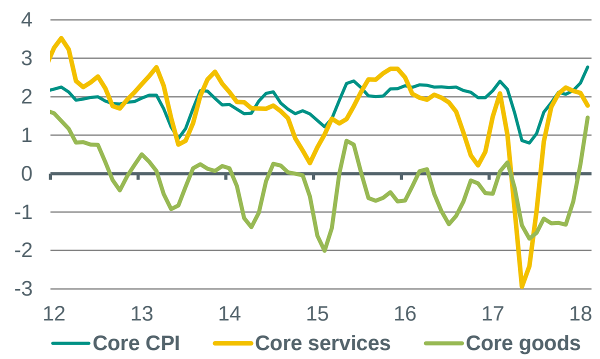
Are wages a bigger driver for the Fed?

- **While inflation has picked up recently, we do not believe next week's (expected) Fed rate hike will be in response to this**
- **Instead, the stronger labour market – helped by strengthening growth momentum – will be the main driver, in our view**
- **While we expect the Fed to continue hiking in response to stronger wage growth this year, the risk of a quicker-than-quarterly rate hike pace is very low**

1. Fed March hike will not be in response to higher inflation
We expect the Fed to raise interest rates again at next week's FOMC meeting. While inflation has picked up in recent months, we do not believe this will be the main driver of the hike. Indeed, we continue to expect inflationary pressures to remain broadly muted this year, given that the drivers of the recent rise have had little to do with the tight labour market, but rather what is likely to be temporary strength in core goods (particularly apparel), and higher car insurance premiums following hurricane damage last year. The chart opposite shows that momentum in core services inflation – which is more influenced by labour market pressures – has in fact cooled recently. But if not inflation, what *is* driving the Fed to continue hiking?

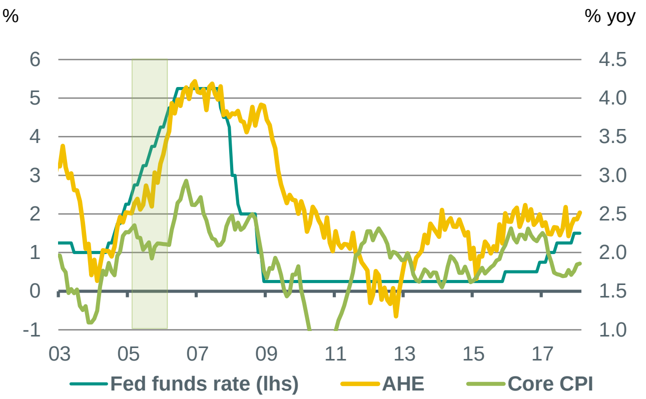
Rise in inflation has been driven by core goods



Core goods = 'Commodities less energy services', while Core services is the 'Other services' aggregate, which excludes shelter, medical & transportation.
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

2. The Fed appears more responsive to labour market conditions
Over the course of an economic cycle, the fed funds rate is typically more responsive to wage growth than it is to core CPI inflation. This makes sense, given that monetary policy works with a lag, and wage growth is a better leading indicator for sustainable trends in core inflation than current inflation. We highlight two notable recent experiences in particular – 1999, and 2005 (visible in the chart opposite). Average hourly earnings growth and the fed funds rate rose markedly over this period, even as core inflation fell back. Inflation did eventually catch up with wage growth, and so hindsight suggests the Fed was wise to respond to labour market strength at the time. We are sceptical that wage growth will translate so quickly to higher inflation this time around, however, and this is why we see the risk of the Fed hiking at a faster-than-quarterly pace to be extremely low.

The Fed continued to hike in 2005, even as inflation fell

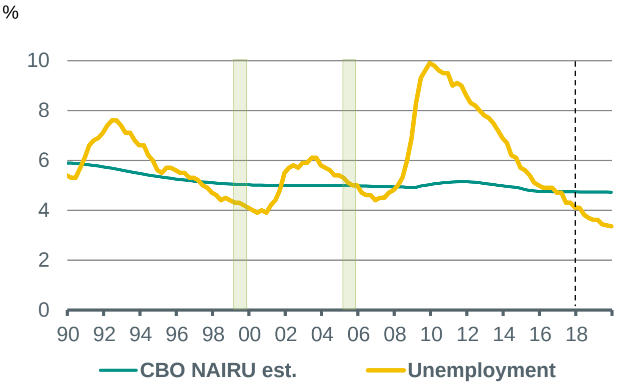


AHE = average hourly earnings (manufacturing, as this has a longer history).
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

3. The broader labour market backdrop is also important

Furthermore, it is notable that in both 1999 and 2005, the unemployment rate was either at or below the CBO estimate of the 'natural' rate of unemployment, or the NAIRU. As a further cross-check, we looked at FOMC statements from both time periods and found there were explicit references to the fact that inflation had fallen back or was relatively low, but that strength in the labour market (among other things, such as easy financial conditions and strong growth momentum) justified a continued tightening of monetary policy. In other words, it is a rather similar situation to the one we find ourselves in today, and this is likely what is behind the hawkish shift in Fed speaker communication.

Unemployment was at / below NAIRU in 1999 and 2005

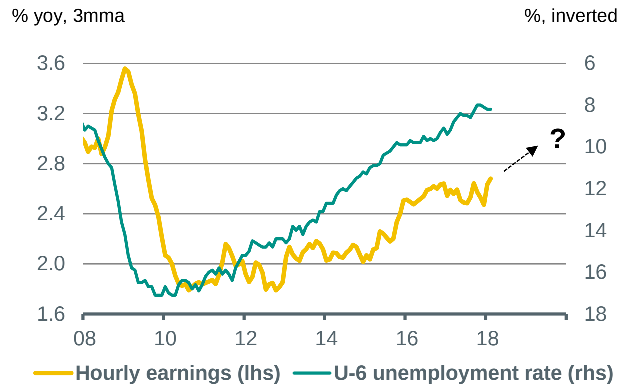


Shaded areas are when the Fed hiked as wages accelerated, but inflation fell.
Source: Thomson Reuters Datastream , ABN AMRO Group Economics

4. Labour market developments will be crucial in guiding the Fed

Wage growth disappointed somewhat to the downside in last Friday's payrolls report, but smoothing through the volatility, the 3 month moving average hit 2.7% yoy, the fastest pace since 2010. We expect the strength in the labour market observed in recent reports to persist over the coming months, given accelerating growth momentum, and this should be a further tailwind for wage growth this year. However, there remains uncertainty over the degree of slack still in the labour market, and whether for instance participation might recover in response to strengthening conditions. All told, we expect three 25bp hikes from the Fed this year, with the risk of a fourth, should wage growth accelerate to the highs we saw prior to the financial crisis (c.3.5% yoy). However, the bar for hiking at a quicker pace than this is very high, in our view.

We expect wage growth to continue to gradually firm



Source: Thomson Reuters Datastream , ABN AMRO Group Economics

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