First Trust
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Dual Mandate Achieved: Rate Hikes Coming

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From 45,000 feet, it certainly looks like the Federal Reserve has achieved, or is very close to achieving, its Dual Mandate of price stability and full employment.

What this means is that the Fed can declare victory. After all the grief it has taken, this must feel pretty darn good. However, it also suggests the Fed has some major decisions to make. According to Keynesian models when the economy hits "full employment," inflationary pressures start to build and the Fed must cut those off before they start.

This is especially important when monetary policy is very accommodative and interest rates are near zero. We think this is why the Fed is still on track to hike interest rates this year.

It's true that overall consumer prices are likely to plummet by around 1% in January and the CPI will be down from a year ago. Some call this "deflation," but we all know it's driven by huge declines in gas prices. "Core" inflation – which excludes food and energy – is up 1.6% from a year ago as of December, and has remained very stable the past few years. We have always thought the term "price stability" should mean zero inflation, but many Keynesians say it should be about 2%. So, if we go with their definition, the US is very close to price stability.

Some argue this means the Fed should hold rates steady – until it sees a true increase in inflation. But the Fed doesn't have that luxury. It must cut off inflation before it starts. The Fed worries about inflation expectations and its models suspect wages are a driving force.

Given the strength of recent employment reports, those models have to be moving future inflation forecasts upward.

Nonfarm payrolls are up more than one million in the past three months, the largest gain for any three-month period in either the current expansion or the one under President Bush in the prior decade. You'd have to go back all the way to late-1990s to find the kind of job growth we're getting now.

Also, the current recovery in jobs has been broad-based. A diffusion index shows that 66.2% of industries have increased employment in the past year, the highest since 1998.

More labor competition is pushing up wages. In January, average hourly earnings rose 0.5% in spite of what everyone expects will be a huge decline in the consumer price index. The Employment Cost Index has also accelerated, while the "quit rate" – those feeling confident enough about the job market to quit their jobs – is up to 9.5%, the highest level since 2008. To top it off, the labor force is up 1.4 million from a year ago.

Some argue the job market is not healthy and we have some sympathy for this view. Full-time workers were 52.3% of the civilian non-institutional population (16+) before the recession started. Now they're only 48.3%. But that doesn't mean it's not up since the recession ended. The low was 46.6% in late 2010 and it's been trending up the past four years. Moreover, it was 48% on average in the 1970s, back before the mass entry of women into the workforce.

One reason job growth and the labor force were slow to mend in the current recovery is that redistribution is on the rise. Social Security Disability rolls have doubled in a decade and that means many can retire even earlier than they would normally. Student aid (loans, grants and subsidies) are also booming, pulling many younger people from the labor force.

These forces may not be "good," but they are "real" and with unemployment under 6% of the labor force, the US is close to "full employment." That's why the labor force and wages are starting to grow more rapidly. This is the Fed's conundrum. Policy has been extremely loose for a very long time and moving to normalize it at this point has minimal risk.

On top of all this, the Fed doesn't know for sure whether it can actually push rates up when the banking system has record levels of excess reserves. It must find this out sooner or later.

Fed Chair Janet Yellen is set to testify to Congress on monetary policy in two weeks. Look for her to put extra emphasis on improvements in the labor market and downplay recent inflation readings as "statistical noise." The coming rate hike cycle is likely to be gradual, but it's coming, sooner than many think.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-12 / 7:30 am	Initial Claims – Feb 7	287K	**288K**		278K
7:30 am	Retail Sales – Jan	-0.5%	**-0.5%**		-0.9%
7:30 am	Retail Sales Ex-Auto – Jan	-0.5%	**-0.5%**		-1.0%
9:00 am	Business Inventories – Dec	+0.2%	**+0.1%**		+0.2%
2-13 / 7:30 am	Import Prices – Jan	-3.2%	**-3.5%**		-2.5%
7:30 am	Export Prices – Jan	-0.9%	**-1.2%**		-1.2%
9:00 am	U. Mich Consumer Sentiment- Feb	98.1	**98.6**		98.1