JUNE IS LEADING CANDIDATE FOR FED LIFTOFF

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Last Friday, Professor Jeremy Siegel and I sat down with Richmond Federal Reserve (Fed) president Jeffrey Lacker. Given the strong March employment report delivered that morning, it was an especially timely conversation, focused around the timing to get off the zero lower bound interest policy rates. Professor Siegel started the discussion by noting that we had seen six months of consecutive job growth and unemployment falling to a new cyclical low of 5.5%—very close to the Fed's natural unemployment rate target. He suggested that this translates to less slack in the economy and raises prospects for the Fed raising rates. On the back of this strong jobs report, interest rates on the 10-year bond spiked up from 2.11% to 2.25%. Higher bond yields put pressure on the U.S. stock market—as is often expected from a fair value exercise that incorporates a classic discounted cash flow perspective for valuing stocks. Lacker discussed how the labor market was improving faster than expected. He pointed to the job flows: the JOLTS data showing job turnover was indicative of a stronger labor market. Job openings are up, job quits are up—which means people are willing to take a chance to get a new job and have confidence in their labor prospects. **What does this mean for Fed policy?** With a strong labor market report confirmation, June strikes Lacker as the leading candidate for liftoff from the Fed's zero interest rate policy. *The market—judging by the Fed fund futures market—still hasn't reconciled these views, as it's still pricing in September for the first hike in rates. Lacker is doing his part to prepare the market for the shift in policy to occur sooner.* **How might wage pressure, declining commodities and a strong dollar cause the Fed to run below its target of 2% inflation?** Lacker believes we need to focus on what real interest rate the economy needs to grow at a non-inflationary pace. In the 1970s, the Fed believed it needed a lower real interest rate to support the economy and did not get it right (the policy caused very high inflation). Lacker further believes the economy is picking up and the Fed clearly needs higher interest rates. Lacker said there are going to be fluctuations from 2% inflation (sometimes inflation will be as high as 4%, as it was a year ago, and sometimes it will be -1%), but if the Fed is confident the swings are transitory, then it can take volatility in inflation in stride. **Strong jobs…weak gross domestic product (GDP). What's causing disappointing productivity?** Lacker believes the overall GDP headline number is pretty volatile due to inventory swings, net imports from oil and weak overall net exports. But Lacker takes comfort from consumer spending and business investment. The U.S. consumer is more confident in employment prospects and we saw consumer confidence surge in Q4.[1] Productivity swings take a long time to decipher and understand. What Lacker hears from businesses are concerns on regulatory impediments (labor, environment, new regulations) and compliance issues making them cautious about investments. But there are also very real skills gaps in selected areas. We don't know in quantitative terms how much of a drag this is causing, but it is real according to Lacker. Lacker also believes credit is still constrained, and he points to small-business formation being lower than it used to be. Small businesses used to finance expansion by using their homes to borrow against, but that is harder now, and Lacker links this to this poor productivity (presumably resulting from a lack of investments). **The dot plot contained in the Fed's Survey of Economic Projections shows a long-run Fed Funds Rate of almost 4%—if the Fed achieves its 2% inflation target. That means the long-term real rate would be 2%, about equal to its historical average. Would Lacker revise down his forecast?** Lacker put in a number for the dot plot that is close to the historical average of near 4%, but he is very open to recent data that suggest we may see a lower real rate over the next 10 to 20 years. **Is the dollar creating tightening for the Fed?** Lacker said the strong U.S. dollar is just one of the things going on and should be expected because the U.S. economy is stronger than other economies, necessitating a rise in real rates in the near term, and that should be expected to generate a rise in the dollar. **The bottom line?** There is a lot of angst and hand-wringing over the U.S. economy. Given the headwinds we have faced, Lacker believes the U.S. is doing remarkably well. Clearly, the U.S. is still one of the best places in the world to implement new ideas and technologies, and fundamentally, he is very optimistic about the U.S. economy. *I greatly appreciated the opportunity to hear the views of this FOMC voting member as the market* *grapples with improving economic data that may finally begin normalization of the Fed's interest rate targets. Read the Conversations with Professor Siegel series here.* [1]Source: Bloomberg.

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DEFINITIONS

Zero-bound policy rates : central bank policy rates close to the 0% level.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Inflation : Characterized by rising price levels.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Dot Plot : a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.