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GFC ECONOMICS

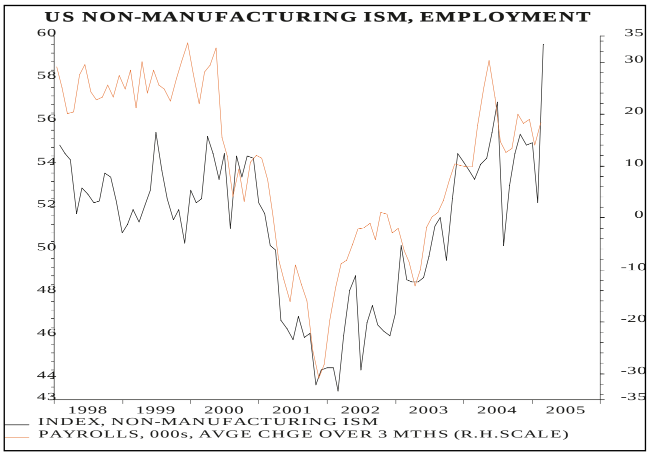
DAILY COMMENTARY

STRONGER PAYROLLS POINT TO HIGHER RATES

Treasuries enjoyed a powerful rally on Friday, despite an essentially strong non-farm payroll report. The run of positive economic numbers had led the market to believe jobs growth could be even higher than the 262,000 increase witnessed last month. Nevertheless, the pressure at the short end of the curve remains, and the trend towards a flatter yield curve is showing distinct signs of reasserting itself. Even so, longer dated maturities may yet come under further selling pressure. Last week's monthly consumption report highlighted a significant acceleration in core inflation during January, testimony to the pervasive impact of the US$'s long term decline. The upward revisions to the productivity numbers confirm that the chief threat to inflation is external and not domestically generated cost pressures. And with retail spending showing no sign of slowing, the risks of a further sharp deterioration in the trade numbers over the coming months remains high. That in turn suggests the recent slippage in the US$ is likely to intensify, threatening a bigger pick-up in goods inflation during the course of 2005. The housing and borrowing numbers suggest the gradual tightening of monetary policy is working. But as always, the lags are long. Both short and long rates are set to climb further, before the US economy slows sufficiently to bring the external deficit down to levels consistent with price stability.

Payrolls Accelerate

February's pick-up in payrolls was so well flagged by other labour market indicators, that in the end, the report failed to trigger a further sell-off in Treasuries. Nevertheless, the acceleration in hiring was widespread. Healthy gains in services and manufacturing employment corroborated the recent improvement in the ISM surveys, help wanted index and jobless claims. For the first time since the economic recovery began in earnest during the spring of 2003, all the important labour market indicators are pointing in the same direction. The pick-up in the help wanted index is arguably the most important of these. It has traditionally been something of a lagging indicator and in this sense, is of limited value. But the index had been running along at unusually depressed levels since it hit a low-point in May 2003, suggesting something was amiss with the labour market. Now that it is turning up, there is every reason to believe the pick-up in hiring is for real. The sharp bounce in the non-manufacturing ISM survey suggests payrolls could be up by more than 300,000 next month.



Of course, the report was not uniformly strong, with a soft household survey, flat average earnings and an unchanged workweek all taking some of the lustre off last month's jobs growth. The 97,000 drop in household employment should not be of too much concern. This survey has a poor track record, and the small sample size implies the data can be quite volatile. More significantly, the recent trend in average hourly earnings has been disappointing, and has provided a significant drag on the growth in wages and salaries. While January's data was revised up, the 6-month growth rate dropped to a new low of 1.0% last month. Average hourly earnings are still contracting in real terms, falling 0.3% y/y in February. And with the average workweek showing no sign of turning up, the outlook for wages and salaries growth remains a worry. The composite of hourly earnings and aggregate hours was up just 0.2% m/m in February. The 6-month growth rate has dipped again to 2.1%. In year-on-year terms, this composite measure of wage growth dropped to 4.7%,

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a rise of 1.8% on a real basis.

The sluggish growth in real wages highlights the dilemma facing the Fed. The economy is strong, but a significant part of the momentum has come from record borrowing rather than real incomes growth per se. The problem is being reinforced by the resurgence in oil prices. Base effects alone suggest headline inflation should fall back in the coming months. But if oil prices keep trending higher that may not happen, and real wage growth may struggle to get much above the 2.0% y/y threshold during the first half of this year. The threat to inflation from the falling US$ is no less important, a point underlined by the sharp rise in the consumption deflator for January. Goods prices are accelerating again. The durables deflator was up 0.5% m/m, the biggest monthly gain since April 1993. The recent strength of import prices suggests the pressure on core inflation from higher durable prices may intensify in the coming months. Import prices for consumer goods excluding autos for example, are now rising more rapidly than anytime since the US$ began to slide in the early months of 2002.

However, the longer-term implications of this squeeze on real wages are less straightforward. The excessive dependency on credit growth to fuel the economic upswing means the secular risks from an acceleration in durables inflation and oil prices are limited, for a number of reasons. First and foremost, the economy should prove quite sensitive to the progressive tightening of monetary policy. The signs of a slowdown in borrowing are already self-evident. The growth in home equity loans has slowed sharply, with the 3-month growth rate dropping to a new low of 3.6% in the final week of February. That was well down from last October's peak of 10.8%. Similarly mortgage applications have been subdued so far this year, running significantly below the average levels of 2004. And while the new home sales data for January may have been impacted by adverse weather in some parts of the country, there has still been some slippage in property inflation of late. The 6-month rate of change in house prices has dropped from a high of 11.0% in October last year, to -0.1%. This particular data series has proved quite sensitive to the swings in borrowing costs. But the drop in bond yields during the final months of 2004 has yet to lift house prices, suggesting the property cycle may just possibly be starting to run out of momentum.

The second, and arguably more decisive factor underpinning the benign secular outlook for inflation remains the strong trend in productivity. Last week's revisions to the productivity numbers were not entirely unsurprising, given the changes to the GDP data in Q4. Output growth in the business sector was duly revised up from an annualised rate of 3.3% to 4.2%. But the hours data were revised down too, from 0.8% to 0.5%, boosting the rise in productivity to an annualised 3.7%. Indeed, for the whole of 2004, productivity growth averaged an impressive 3.9% y/y, some way above the Federal Reserve's own estimate of the trend. Given that the working-age population grew 1.0% y/y last year, that implies the potential growth path of the US economy was running at approximately 4.9% last year. This is somewhat above the 4.4% rise in real GDP witnessed during 2004.

In this context, it is perhaps unsurprising that core service sector inflation - arguably a better reflection of domestically generated price pressures - actually fell last year. Of course, headline and overall core inflation still accelerated, due to the ongoing energy crisis, the slide in the US$ and the impact of China's boom on raw material prices. Therein lies the rub for the Fed. The gap between sluggish real wages and the potential growth path has essentially been filled by the housing boom. But that in turn has spawned an unsustainable, record current account deficit that is threatening to send the US$ spiralling lower during the course of 2005 and beyond. The only policy resolution is higher rates, even though in the long run, that will exacerbate the widening gulf between domestic demand growth and the potential growth path, and reinforce the secular case for a fall in domestically generated price pressures.