PANTHEON MACROECONOMICS

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The strength of payroll growth is remarkable, and largely sustainable through spring at least.

Unemployment will keep falling, and wage pressures are beginning to emerge.

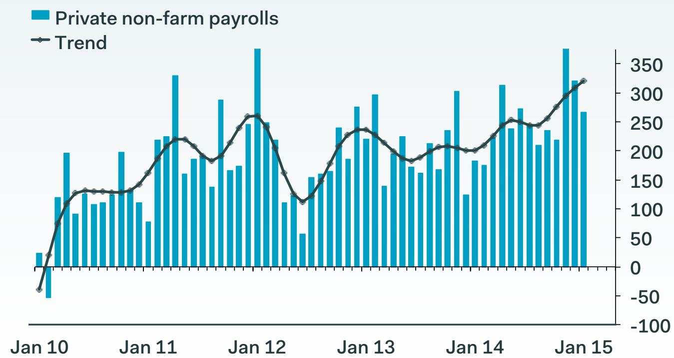
Chair Yellen will be hawkish at her Testimony this month; the March FOMC will signal a June hike .

Labor Data Forcing the Fed Into a Corner; "Patient" to go in March

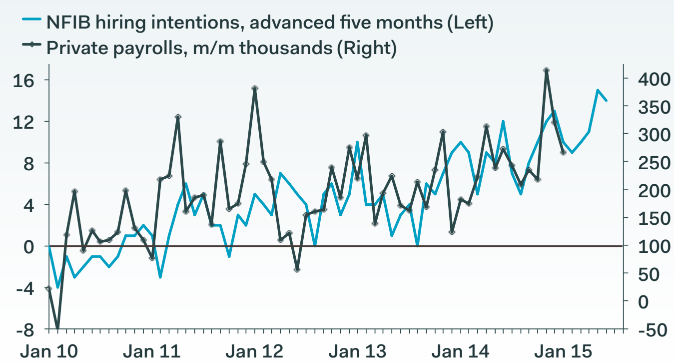
It's always easy to find reasons to doubt single monthly observations of any economic time series, but our first chart makes it very clear that the labor market has strengthened markedly over the past few months. ***The underlying trend rate of growth in private payrolls is now above 300K for the first time in exactly 20 years, and we seen no reason to expect much change over the next few months.*** The NFIB hiring intentions index, which has been a reliable leading indicator in recent years, suggests payroll growth will be close to January's *relatively* sedate pace for the next couple of months, before re-accelerating back above 300K in the spring.

With employment growth at that sort of pace, even a rapid increase in the participation rate would not be enough to prevent a further clear decline in the unemployment rate. The one-tenth increase in the January rate is of no significance. Since unemployment peaked in October 2009, the rate has dropped by 4.3 percentage points, but month-to-month increases have been recorded on 13 occasions. *In other words, even when the underlying trend is falling just about as fast as we can reasonably expect, over an extended period, it will be reported as rising almost once every five months.*

THE TREND IN PAYROLL GROWTH IS ROCKETING...

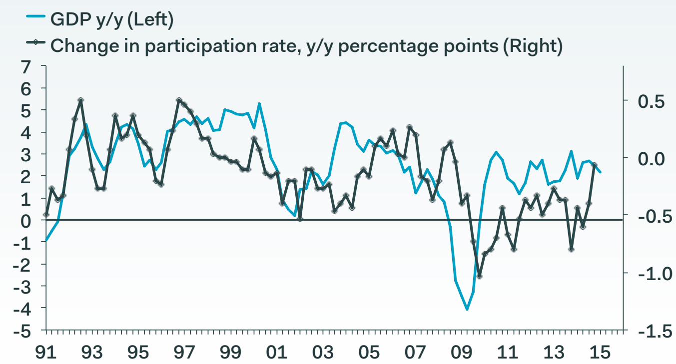


...AND THE BEST LEADING INDICATOR SIGNALS FURTHER BIG GAINS



We buy the idea that participation will gradually increase over the next couple of years; the trend appears already to have stopped falling, though the short-term data are very volatile and clear shifts in the trend can take a long time to emerge. *But the macro story points clearly to rising participation: Over time, sustained GDP growth of about 2¾% or more is enough to start pushing participation higher.* Growth is not quite at that pace in year-over-year terms, but it will be very soon, and the average quarterly annualized rate in the second half of last year was a robust 3.8%. Our next chart, on page two, clearly suggests that the unprecedented five-year period of unusual softness of the participation rate, relative to GDP growth, is now over.

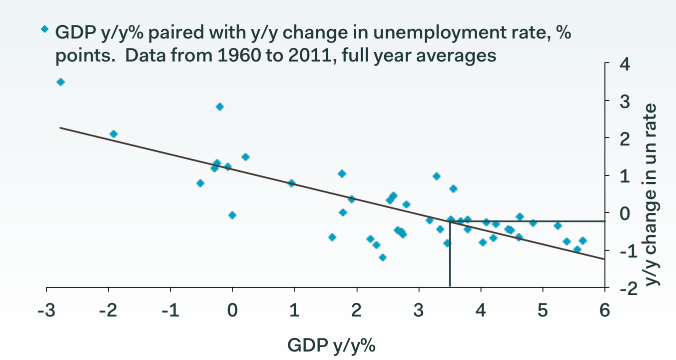
GDP GROWTH AND PARTICIPATION ARE RE-CONVERGING, AT LAST



Most of the shortfall in participation has been among women; male participation, relative to GDP growth, has behaved more or less normally for most of the time since late 2011. We have long argued that womens' participation shortfall was largely a reflection of their preferred employers—small businesses and state and local government—both of which have been very slow to return to hiring. *But small firms have massively stepped up their recruitment—state and local government is still soft—and that will pull women back into the labor force.*

If the previous, long-term relationship between economic growth and the rate of change of unemployment is now reasserting itself, history suggests that GDP growth of 3½%—our forecast for this year—will push the unemployment rate down by only a couple of tenths, as our next chart shows. That would give the Fed a great deal more room for maneuver on interest rates than would be the case if unemployment continued to drop at the pace seen

UNEMPLOYMENT WILL FALL FASTER THAN HISTORY SUGGESTS



over the past four years, because that would put the rate at just 4½% by this time next year.

We think, however, that unemployment will fall more quickly than the chart suggests, for two reasons. First productivity growth remains very sluggish, perhaps because of the shortfall of capital spending since the crash. *An ageing capital stock makes it more difficult to extract productivity gains, and for a given rate of GDP growth, slower productivity growth means faster payroll gains and a more rapid decline in unemployment.* Second, the pool of labor which is of interest to employers likely is smaller than the headline data suggest, because small firms are reluctant to hire people who have been out of work for an extended period. *That's why the NFIB survey shows firms can't fill job openings, despite the millions of people who have left the labor force or want to switch from part-time to full-time work.*

Ultimately, what matters to the Fed is the pace of wage gains rather than the unemployment rate. The rebound in wage gains in January, following the December dip, does not change the big picture. *But at least the previously yawning gap between the rates of growth of hourly earnings and the private wage and salary component of the employment costs index has been much reduced.* In the year to January, hourly earnings rose 2.2%, while ECI private wages rose 2.3% in the year to December. We can't yet definitively call a turn in the hourly earnings numbers, but the more reliable ECI data are clearly trending higher.

The Fed cannot sit with monetary policy set to prevent the end of the world when the labor market is moving so fast and every leading wages indicator we know is screaming that pressure is building. Yes, core inflation is very low and likely to fall further over the next year, but monetary policy lags are very long and policy is firmly at the end of the easing spectrum. We expect Chair Yellen to signal a hardening stance at the Fed in her Monetary Policy Testimony later this month, paving the way for "patient " to be dropped at the March FOMC, and rates to be raised in June.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 9

- **No significant data released**

Tuesday, February 10

- **D: Redbook Chain Store Sales (2/7)/9:00 EST**

We expect a further uptick towards the 4¼% trend from last week's **3.8%** year-over-year.

- **D: NFIB Survey (1)/9:00 EST**

We expect a modest increase to **101**—an eight year high—from 100.4, after December's leap. **Consensus: 101.5.**

- **Wholesale Inventories (12)/10:00 EST**

We look for a small **0.3%** increase, with falling gas prices pushing down the non-durable goods component, offsetting some of the increase in the durables component. **Consensus: 0.2%.**

- **D: JOLTS Report (12)/10:00 EST**

The strength of payroll gains suggests the number of job openings will rise yet again, to perhaps a 14-year high of **5.0M,** up from 4.972M. **Consensus: 4.975M.**

Wednesday, February 11

- **Mortgage Applications (2/6)/7:00 EST**

Seasonal adjustment distortions mean the purchase index likely will fall sharply from last week's **187.2**.

- **Treasury Budget (1)/14:00 EST**

The CBO reckons the deficit was $18B, up from $10B a year ago. **Consensus: -$3.0B.**

Thursday, February 12

- **D: Initial Jobless Claims (2/7)/8:30 EST**

Continued seasonal distortions should push claims up to **300K** from 278K, but just about anything could happen, again. The trend is about 290K. **Consensus: 288K.**

- **D: Retail Sales (1)/8:30 EST**

The combination of plunging gas prices and weak core sales, due in part to severe weather, means both headline and non-auto sales should fall by **1%. Consensus: Total sales -0.5%, sales ex-autos -0.5%.**

- **Business Inventories (12)/10:00 EST**

Total inventories should rise **0.1%,** the smallest increase since August, but falling gas prices mean the real increase will be rather bigger. **Consensus: 0.2%.**

Friday, February 13

- **Import Prices (1)/8:30 EST**

The continued drop in oil prices last month means total import prices should drop by **2.5%. Consensus: -3.3%.**

- **D: Univ. of Michigan Sentiment (29)/9:55 EST**

Little change likely from the preliminary **98.1**, up from 93.6 in December. **Consensus: 98.1.**

THIS WEEK'S FUNDING

Monday 9	Announcement: 4-week bills (Feb. 10) Auction: $26B 3-month, $26B 6-month bills
Tuesday 10	Auction: 4-week bills Auction: $24B 3-year notes (settles Feb. 17)
Wednesday 11	Auction: $24B 10-year notes (settles Feb. 17)
Thursday 12	Announcement: 3-month, 6-month bills (Feb. 17) Auction: $16B 30-year bonds (settles Feb. 17) Announcement: 30-year TIPS (Feb. 19)
Friday 13	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Fri.	**Mar**	**Jun**	**Sep**	**Dec**
Fed funds target	0-to-¼	0-to-¼	0.50	1.00	1.25
2-yr	0.65	1.00	1.30	1.60	2.00
10-yr	1.96	2.10	2.40	2.60	2.75
30-yr	2.53	2.60	2.80	2.90	3.00
Curve 10-2	131	110	110	100	75
Curve 30-2	188	160	150	130	100
S&P 500	2,055	2,025	2,050	2,075	2,100
Yen/Dollar	119.0	122	125	130	135
Dollar/Euro	1.13	1.08	1.00	0.98	0.95
Dollar/Sterling	1.52	1.48	1.46	1.45	1.45

PANTHEON'S ECONOMIC FORECASTS

GDP	Q1 third	-2.1%	2011 year:	1.6%
	Q2 third	4.6%	2012 year:	2.3%
	Q3 third	5.0%	2013 year:	2.2%
	Q4 advance	*2.6%*	2014 year:	2.4%
	Q1 forecast	*3¾%*	*2015 year:*	*3¾%*
	Q2 forecast	*3¾%*		

CPI	Dec. -0.4% (0.8% y/y); core 0.0% (1.6% y/y)
	June 2015 forecast: 1.0% y/y; core 1.5% y/y
	December 2015 forecast: 1.% y/y; core 1.8% y/y

Unemployment: June 2015, 5.1%; December 2015, 4.5%

Federal budget: FY 15 forecast: -$400B (2.3% of GDP)