# Economist Insights

## *Splendid isolation*

When the US Federal Reserve chose not to hike rates in September, the market zoomed in on the one line expressing the Fed's sudden concern about the wider global economy. Suddenly a rate hike in December was deemed unlikely. Then last week the Fed reversed course and went back to its usual domestic focus. Sure enough, an imminent rate hike was priced back in. But is the data pointing to an altogether different scenario?

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The British Empire of the 19th century was once described as living in "splendid isolation", looking to its own interests alone and ignoring the troubles and travails of Europe. Up until September, the Federal Reserve could have been described in much the same way: living in splendid isolation, focusing on the domestic economy and largely ignoring the turmoil and turbulence of the global economy. But suddenly the FOMC added a line to their monetary policy statement arguing "global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term". For a brief, wondrous interval it looked as if the Fed's decision on whether to hike depended on how the global economy was doing.

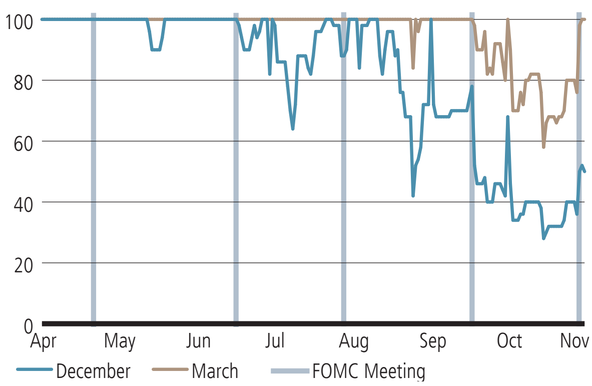
Then just as suddenly, in their statement last week, the Fed removed all reference to the global economy. From splendid isolation to global focus back to splendid isolation, all in the space of six weeks. Why the reversal? It is all down to communication. The market became so focused on that one phrase that it dominated the domestic economy. But this is not what the Fed meant, they simply thought it was worth mentioning that this is one of the factors that they consider. Fed Chair Janet Yellen even felt that she had to curb the market's enthusiasm, arguing that the committee did "not currently anticipate that the effects of these recent developments on the U.S. economy will prove to be large enough to have a significant effect on the path for policy".

It is not as if the Fed did not think about the rest of the world before the September meeting. One just has to look at the staffing. The central Federal Reserve alone has 83 economists and other researchers listed as wholly or partially undertaking research on international economics. And that does not even include all the economists at the twelve regional Federal Reserve Banks. No organisation (even one that can print money) would expend that much time and effort on a subject if they did not think it would ultimately affect their decisions.

Earlier this year, the market had been certain that the first rate hike would have come by the end of the year (chart 1). When the Chinese stock market took a hit in July the first doubts to creep in were soon dismissed. But then when Chinese data took a turn for the worse in August and the S&P500 plunged, markets started to reduce their probability of a rate hike. It was the mention of global considerations though, after the September meeting, that really sent expectations of a December start plunging. The market assumed that the Fed was as worried about the global economy as they were.

**Chart 1: Splendid disbelief**

Market pricing of probability of at least one rate hike in December 2015 or March 2016, from April this year (%)




Source: Bloomberg Finance LP, UBS Asset Management
Note: Calculated as how close the difference in the appropriate Futures contract less the daily effective Fed Funds rate is to 25 basis points.

Since September the world economy has not been great, but nor has it been as disastrous as the equity markets were implying. It is more likely that the Fed was simply acknowledging a risk, rather than a central scenario. From the Fed's perspective, it may have looked a bit odd not to have mentioned the global risks. But the market focused on just that one line and ran with it. The Fed must be thinking: if you are not going to be grown up about it, then we are not going to tell you about the risks any more.

**Overcompensating**

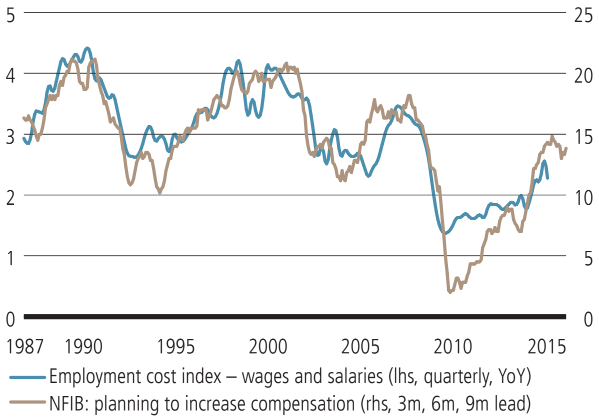
As any employer knows, the costs of hiring someone amount to more than just the monthly paycheck. There are taxes, social security contributions, medical insurance, and so forth. If you double an employee's medical insurance, but do not change their wages, this is still an increase in the cost of hiring someone. This is just one reason why the Fed, and almost all economists, prefer the more all-encompassing Employment Cost Index (ECI) for measuring wage pressure. Unfortunately this measure of compensation only comes out quarterly, so the ever-impatient market chooses to focus on the more frequent but less useful monthly wage data.

The National Federation of Independent Business conducts a survey of small firms, and a key question that it asks is whether firms expect employee compensation to increase over the next 6-9 months. As small firms are price-takers rather than price-makersthis makes them a good barometer of wage pressures, since they need to respond to market changes. The survey tends to lead the employment cost index by about 6-9 months (see *Economist Insights*, 4 May 2015). The last two releases, however, are showing an unwelcome divergence from the historical pattern (chart 2). But history shows that while these divergences may happen, the long-run relationship has always dominated.

The year-on-year number does hide something of a recovery. Quarter-on-quarter the pace of growth of the ECI tripled from 0.2% in the second quarter to 0.6% in the third, roughly the speed it was growing before. The base effects bring it down, but if it grows at the same pace in the fourth quarter, year-on-year growth will still be only 2.1%. Still not suggestive of a very tight labour market, but perhaps indicative that the labour market is gaining traction. This week's labour market report becomes all the more important now.

**Chart 2: Undercompensating**

Employment cost index (YoY) and NFIB survey of respondents expecting employee compensation to rise over the next 6-9 months




Source: NFIB, BLS, UBS Asset Management.

Once the Fed removed the reference to the global economy, the market upped the probability of a hike by December to an even chance, and once again consider a hike by March to be a certainty. But this was probably more to do with how the Fed is phrasing its decision. Whereas before they were wondering how long to maintain low rates, now they are wondering whether to hike at the next meeting. Not only has the Fed decided that the market cannot be trusted to read the statement like an adult, but they are also spelling out just how imminent a rate hike is. Paradoxically, with a weak ECI the probability of a rate hike in December may have fallen at just the same moment that the Fed is less likely to hike.