Investment Focus

Can the Fed tame inflation without driving up unemployment?

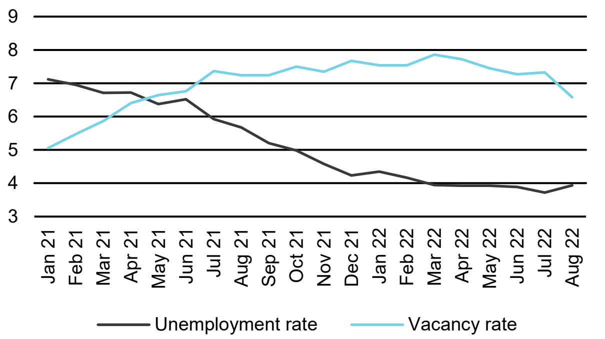
Federal Reserve Board (Fed) researchers, together with academics from East Coast universities, are currently having a heated debate as to whether the US central bank can successfully steer the US economic slowdown to combat inflation without creating significant additional unemployment. Research conducted by the Federal Reserve Board of Governors member, Waller (2022), concludes that monetary policy is precise enough to reduce current job openings (also called vacancies) without significantly increasing the rate of unemployment. Analysis by Blanchard et al (2022), however, reveals the opposite; lower vacancies never go hand in hand with a constant unemployment rate.

This dispute has now attracted the growing interest of investors, given the different and manifold implications its outcome has for the alignment of portfolios. We therefore feel it is worth diving into this controversial discussion to understand the main arguments, assumptions and implications of these two different conclusions. It may also help us grasp the impact of tighter monetary policy on future employment and economic growth in the US.

Both streams of reasoning rely on the relationship between the vacancy and the unemployment rate. It represents an inverse link; whereby high vacancies correlate with low unemployment and vice versa. This relationship is called the Beveridge curve and implies that monetary policy must reduce job openings (labor demand), causing unemployment to rise. Rising unemployment depresses consumption and domestic demand, and therefore economic growth, which unleashes disinflationary forces. The Beveridge curve is not only a cyclical measure. It also contains essential information about how the labor market functions with respect to labor turnover. In addition, an examination of the correlation between unemployment and vacancies can tell us a great deal about the effectiveness of the matching process, as well as about the nature of shocks affecting the labor market.

11 million job openings, which equate to a vacancy rate of nearly 7%, are at their highest rate for the last two decades. Together with an unemployment rate of 3.6%, close to the level observed before the outbreak of the COVID-19 pandemic, this relation describes very well the current US labor market tightness.

Vacancy and unemployment rates in the US (in % of total employment)



Source: US Bureau of Labor Statistics, Vontobel SFA

The Fed's argument – the optimistic view

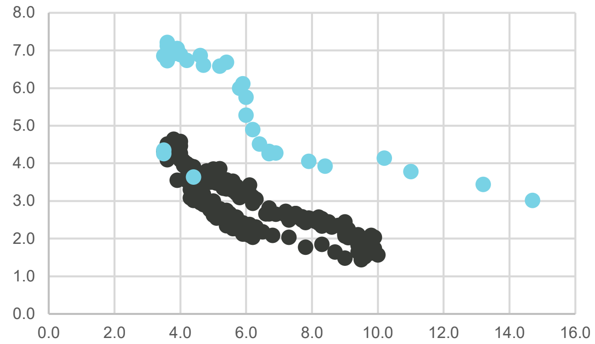
The Fed's argument runs as follows: one should compare the combined vacancy and unemployment rate scenario before COVID-19. On average, the vacancy rate was 4.4% and unemployment averaged at 3.7% in 2019. The vacancy rate has now reached approximately 7%, around three percentage points above the pre-crisis level. Unemployment is hovering around the pre-crisis level of 3.6%. If the probability of finding a job is high and the likelihood of being unemployed is low, which is a fair assumption for the current US labor situation, the central bank should be able to lower job openings without impacting the unemployment rate significantly. This is for a given degree of matching efficiency. The crucial assumption of this optimistic view of the impact of future tighter financial conditions on US employment and economic activity is the belief that the matching technology bringing workers and jobs together has not changed in the aftermath of the COVID-19 pandemic.

The academics – the more pessimistic view

But what happens to the outcome if the assumption of unchanged matching technology is relaxed. The term "matching technology" refers to the scenario where jobseekers and employers engage in a "search and matching" process to find one another. This process is influenced by many factors: the search behavior of individual jobseekers, systemic and social forces, macroeconomic conditions, employers' decisions on recruitment and hiring, and public policies. Researchers use the term "frictions" to refer to barriers that prevent jobseekers from instantly matching with employers, and both parties encounter a variety of frictions in the labor market.

Has this matching technology changed as a result of and during the COVID-19 crisis? This is exactly the objective of the investigations of the very recent academic research to challenge the optimistic outcome of the Fed's reasoning. They conclude that the current point on the Beveridge curve – low unemployment and high vacancy rates – is the result of strong aggregate activity and more difficult matching, reflecting both a higher reallocation of labor and a lower matching efficiency. The ratio of vacancies to unemployment, which was stable until COVID-19, decreased sharply at the start of the pandemic, reflecting the sudden drop in activity. It then recovered steadily and now stands at twice its pre-crisis level.

Evolution of the vacancy unemployment ratio (monthly data December 2000 to July 2022)

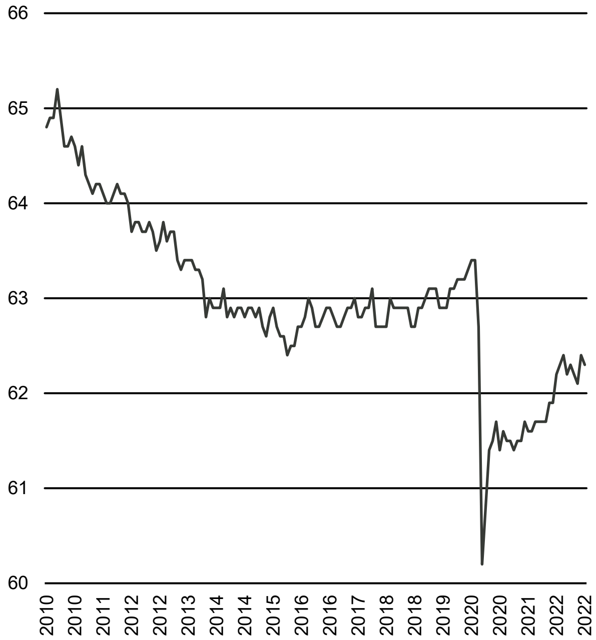


X-axis: Unemployment rate (in %). Y-axis: vacancy rate (in %)
Source: Federal Reserve Bank of St. Louis (FRED), Vontobel SFA

Matching efficiency dropped sharply at the start of the COVID crisis. Despite a great increase in the pool of unemployed persons and a small decline in vacancies, the number of hires decreased. It has recovered partially since then, albeit at a lower level. If matching is normalized to equal 1 in December 2019, matching efficiency equaled 0.8 in April 2022, according to the calculations of Blanchard et al (2022).

This framework yields the following conclusions: the very high ratio of vacancies to unemployment suggests a very strong level of activity and potential overheating of the labor market. The outward shift of the Beveridge curve suggests that other factors have been at work, namely lower matching efficiency and higher reallocation.

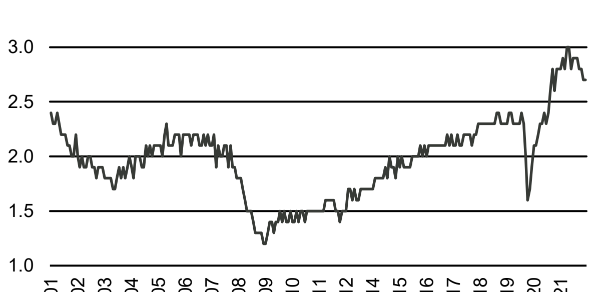
US Labor Force Participation Rate (%)



Source: Federal Reserve Bank of St. Louis

Lower vacancies without much change in unemployment – the desired objective of some Fed officials – would require a large downward shift of the matching ratio. This could happen if either matching efficiency increased or reallocation decreased sufficiently. Blanchard et al (2022) have shown that this is not happening so far and with little evidence of it happening in the future. The COVID-19 crisis will have substantial reallocation implications, especially as the impact of teleworking becomes more apparent. According to an analysis of the US Bureau of Labor Statistics in 2021, huge mismatches between labor demand and supply exist in sectors such as hospitality, construction and transport, where potential supply exceeds demand and in sectors such as teleworking where demand exceeds supply. Further evidence is provided by the participation rates across age cohorts. Total participation in the US labor market stands at around 62%. This is approximately 1.5 percentage points below the pre-crisis level. Participation however, for the 16 to 24 years age cohort is still four percentage point below the pre-crisis level.

US quit rate in % of total employment



Source: US Bureau of Labor Statistics, Vontobel SFA

It is not surprising that higher reallocation, with workers moving across sectors and locations, may lead to a sustained decline in matching efficiency. This also becomes apparent when looking at record high quit rates, i.e. employees who are voluntarily leaving their current jobs for higher paid and higher quality new employment. Tighter monetary policy, which intends to keep the ratio between aggregate economic activity and employment unchanged, is unlikely to shift the matching relation at all. If the matching technology and the reallocation relation is not affected by monetary policy, the Fed could be forced to tighten financial conditions even more aggressively to reach its goal of falling inflation. This may lead to higher unemployment and lower aggregate economic activity. The impact of unemployment on household consumption and job search behavior will determine to what extent and how fast this will happen.

If we take it that the labor market was broadly in balance at the end of 2019, then the ratio of vacancies to unemployment was roughly equal to the natural ratio. This implies that the unemployment rate was also essentially in line with its natural rate. Based on this then, the natural rate of unemployment should have increased from 3.6 percent to 4.9 percent during this period and thus the current unemployment rate of 3.6 percent indicates a positive unemployment rate gap of 1.3 percentage points and a substantial overheating of the economy.

The impact on our asset allocation – the optimistic view
This now raises the question as to how we would organize our portfolios if either of these scenarios materializes? Let's start with the optimistic view that the Fed may be able to lower job openings without causing unemployment to rise. In this case we would closely monitor the development of job openings, which should decline. We would also expect continuing jobless claims to remain below the levels observed before the COVID-19 crisis, as the Fed intends to reduce job openings to their pre-crisis levels of around 4 million. This approach offers the Fed leeway to increase continuing jobless claims by around 200,000 on average and would move the current unemployment rate from 3.7% to the mean unemployment rate for 2019 of approximately 3.9%. This scenario outcome would be consistent with the declared intentions of the Fed.

In such an optimistic scenario we would reduce our cash holdings and switch the proceeds into equities to return to an overweight allocation to global equities. We would also add cyclical equity market exposure, as these markets benefit most from such an economic growth-friendly environment. Earnings growth should accelerate as the global economy gains traction, supported by easing supply chain disruptions. Falling inflation would start to restore the purchasing power of private households and production costs would begin to stabilize. Higher domestic real demand and lower real production costs would also support corporate earnings.

The following steps would be necessary on the bond side. As real yields could rise on the back of strong economic momentum, we would shorten duration in order to avoid capital losses on longer-dated bonds. We would keep our allocation to investment grade corporate bonds, as default risk would likely fade again due to the economic and earnings rebound. We would also maintain our overweight allocation to emerging market debt denominated in hard and local currencies. Although short-term US rates are expected to rise, this increase should be limited, as the Fed only intends to deflate job openings and not employment. The Fed's self-restraint should stop the appreciation pressure on the USD, which would be favorable for emerging market debt.

Currencies also offer opportunities in this recovery scenario. We would add more cyclically-exposed currencies such as the NOK, SEK and the EUR to our portfolios. In addition, commodity currencies, such as the AUD and the CAD, should benefit from the reinforced global economy. Despite easing policy and economic uncertainty, we would maintain our exposure to gold as a portfolio diversifier. A weakening USD may also benefit gold. We would also consider reducing the underweight allocation to global commodities.

The more pessimistic view

Now let us turn to the more pessimistic view outlined by the academics. Their analysis of the relationship between vacancy and unemployment rates in the US reveals a potentially more severe economic downturn and recession ahead. As we have learnt, it is almost impossible to predict the precise impact a tighter monetary policy stance and deteriorated financial conditions would have on unemployment, economic growth and earnings. Even the FOMC members do not know how much tightening is needed or how much time must elapse to generate the intended results. Hence, there is a substantial risk that the Fed may deploy either excessively strong or moderate measures, which may impact on the speed and the size of the target variables (unemployment, economic growth) resulting in a further delay on inflation.

The academic view tells us that we should monitor the development of job openings (vacancies), initial jobless claims and the pool of unemployed. Falling job openings feed into rising initial jobless claims, thus lifting unemployment, curbing domestic demand and decelerating economic activity.

Against this backdrop of heightened uncertainty, we would substantially reduce risks in our portfolios to protect the expected returns of the portfolios and to benefit from diversification across all asset classes. We would reduce our allocation to equities to a significant underweight allocation, especially those equity markets that are more exposed to cyclical risks, such as EA and emerging market equities, including emerging Asian equities. In this scenario, we would also trim our exposure to US, Swiss and Japanese equities, but to a lesser extent as these markets are assessed to be less sensitive to the business cycle.

In the fixed income space, we would apply the following measures. As inflation should ease in the medium-term, we would lengthen duration to benefit from the compression of the term premium embedded in the yields of long-term government bonds. We would also use some proceeds from reducing the equity weighting to invest in high-quality government related debt, which should benefit from the flight to quality. At the same time, we would move out of investment grade corporate bonds, as a deceleration of economic activity usually implies spread widening and a rise in default probabilities across the credit curve. We would therefore also maintain or even increase the underweight allocation to non-investment grade corporate debt. With the severe slowdown of the global economy, rising sovereign risks in the emerging markets and a stronger expected USD we would also change our current overweight allocation to emerging market debt to a substantial underweight. With elevated economic and political uncertainties, foreign investments in risk assets such as emerging market bonds are expected to be repatriated into domestic investments. Some proceeds from moving equities to an underweight allocation would be reallocated to increase our cash positioning. Cash offers a relative cushion against potential losses from traditional fixed income investments and would give us leeway to re-invest in risk assets, should the prospects brighten again.

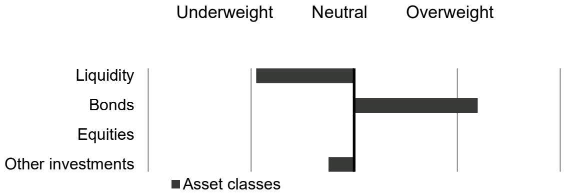
Furthermore, we would alter our currency allocation by reducing our position in the NOK and the SEK, by switching the respective proceeds into safe haven currencies such as the USD, the Swiss franc and the Japanese yen. In light of the higher volatility, we would add to our gold allocation to profit from its diversification potential and to increase the portfolio cushion.

We will see whether the Fed's pragmatic approach or the more complex approach of the academics will materialize. We may even see a hybrid of the two scenarios. As Mark Twain once said: "Prediction is difficult, particularly when it involves the future".

Investment conclusion – stay invested and keep an equity exposure close to the strategic allocation

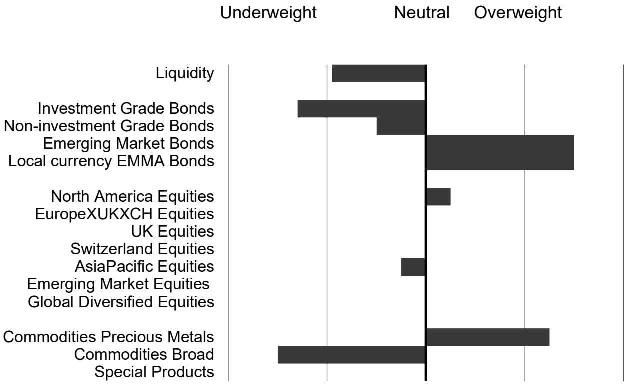
With heightened uncertainty about the size and speed of interest rate adjustments to tame inflation and the respective impact on the economic growth outlook, we have actively decided to maintain an equity exposure close to the strategic allocation. The sharp correction in global equity prices has significantly improved equity valuations since the beginning of the year. Many technical indicators such as put/call ratios and depressed price/earnings ratios, especially in more cyclically exposed equity markets, already suggest attractive entry points. As we cannot predict how high rates must move and how great the impact on economic growth will be, we know that rates are likely to move higher and that economic activity will decline over the coming months. Valuations must therefore adjust, especially when corporate cash flows, future earnings and dividends are also negatively impacted by higher funding costs and slower economic momentum. How far this derating process must go depends on the expected future tightening stance. We therefore feel that a neutral allocation to global equities is an appropriate positioning in terms of risks and opportunities. We are also avoiding any directional allocation across regions. Should equities continue to adjust to the expected new equilibrium of higher rates and slower growth, this positioning should offer some protection for our portfolios. If investors believe the current expected higher rates and lower economic momentum already represents the new equilibrium, our portfolios will benefit from a respective market rebound.

Asset class preferences



Source: Vontobel SFA, as of September 2022, based on PM Global Balanced USD

Sub-asset class preferences



Source: Vontobel SFA, as of September 2022, based on PM Global Balanced USD

Our overweight allocation to gold provides further protection for our portfolios in case equity investors conclude that additional price adjustments are needed on the way to the new equilibrium. This is because gold has proven to be a sound portfolio diversifier, especially during times of heightened economic and political uncertainty.

Furthermore, bonds have gained attractiveness over the past few months as yields in almost all major markets have returned to positive territory. Yield curves in most advanced economies flattened significantly or even inverted during the period of monetary policy tightening measures. Intermediate US government bonds are now paying a yield of around 4% and investment grade corporate debt spreads have risen by approximately 60 basis points to around 1.8 percentage points. Even Swiss government bonds offer a yield of around 1% for maturities of around seven years. This resulted in negative returns this year. Positive equity bond correlations, however, are rare events and should become negative again once the transformation towards the new equilibrium is completed. We are therefore maintaining an overweight allocation to investment grade corporate bonds in our portfolios. This should offer attractive risk adjusted returns, particularly as rising default rates remains limited. Although spreads on US non-investment grade corporate debt (high yield) rose by more than 200 basis points to close to four percentage points, we continue to underweight US high yield bonds. We do not foresee further commodity price appreciations, especially not for energy prices. US high yields are therefore vulnerable if energy prices start to normalize again, given that one quarter of the US high yield market is exposed to the energy sector. Because leverage in the US non-investment grade bond market is much more pronounced than in the investment grade space, tighter financial conditions, higher funding costs and potentially lower earnings growths weigh strongly on high yield corporates.

We are keeping the overweight allocation to emerging market debt denominated in hard and local currencies by investing into globally diversified instruments. This will reduce single issuer risk. Spreads have widened to attractive levels due to the USD appreciation and rising rates in the advanced economies. Although we expect further rate hikes by central banks in the advanced economies current spreads appear to reflect this tighter monetary policy stance. USD strengthening should come to an end once monetary policy starts to moderate. In this case, emerging market debt, especially denominated in local currency, would not only offer spread compression potential but also the possibility of local emerging market currency gains vis-à-vis the USD.

With respect to currencies, we maintain a positive view of the Norwegian krone (NOK) and Swedish krona (SEK). We are holding an overweight allocation to the NOK in our global portfolio and a respective position of the SEK in our international mandates. Inflation is well ahead of the policy target in the Norwegian and the Swedish economies, and both central banks have expressed their concerns that inflation may continue to rise due to wage growth catching up with the underlying inflation trend. To keep inflation expectations well anchored, the Norges Bank and the Riksbank are expected to tighten their monetary policy stance further. This should continue to support the NOK and SEK against our reference currencies.

Another highlight of our current asset allocation is our outlook for Swiss franc denominated assets. Be reminded that yields for most Swiss franc investment grade bonds, including corporate bonds, were until recently still in negative territory. In response to the expectation of higher policy rates and monetary policy normalization even Swiss rates and yields have moved back into positive territory. The 4-year government bond yield now stands at approximately 0.7%. For those investors looking for higher duration risk, the 10-year yield of Swiss government debt is currently hovering around 1.1%. Swiss franc denominated investment grade corporate debt with a 4-year maturity pays a yield of around 2.5%. With current inflation of only 3.2%, the Swiss economy offers inflation stability. Even real yields are close to zero. Although the Swiss franc is a strong currency, it has seen some setbacks against the USD in the very recent past. Although we do not predict a sharp depreciation of the USD in the nearer future, the Swiss franc offers attractive diversification opportunities, especially for US investors. Our Swiss franc-based equity portfolios are mainly focused on Swiss companies with solid cash flow generating business models of mainly large sized companies without a sector or investment style tilt. When assessed as appropriate, we use middle and small sized companies to enhance the return of to increase the level of diversification.

Related literature
Blanchard Olivier, Domash Axel, and Summers Lawrence, 2022, "Bad News for the Fed from the Beveridge Space", Peterson Institute for International Economics

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Waller Christopher J., (2022), "Responding to High Inflation, with Some Thoughts on a Soft Landing", Institute for Monetary and Financial Stability Distinguished Lecture, Goethe University, Frankfurt, Germany

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