ANALYZING THE UNEMPLOYMENT RATE AND THE FOMC

by Steve Brown

Depending on your age you might be thinking of retirement at some point. That is one reason we found a survey by Employee Benefit Research Institute interesting. It found 37% of workers say they expect to retire after age 65 and yet, the median age of retirement since 1991 has remained about 62. Despite all the hype around 401(k)'s becoming 201(k)'s given the recession, that is an odd situation, so what gives? The study found about 50% of people are forced into retirement for various reasons that include health problems (51%); lay offs or company closure (21%); caring for a family member (19%); or not having the skills to do the job anymore (11%). No matter the economic picture, these issues remain, so look for the retirement age to hold about where it is for the foreseeable future. Speaking of interesting things, the recent announcement by the Fed that the level of interest rates will be linked to the unemployment rate is completely new. However, this should not be too surprising, as this is really a confirmation of current practice, rather than a change in direction. Monetary policy generally follows a modified version of the Phillips Relation, which depicts a negative function between the rate of inflation and the rate of unemployment. The original model as designed by A. W. Phillips in 1958 applied to wages, instead of unemployment. A summarized explanation of the Phillips Relation is that a decrease in unemployment creates inflationary pressure by increasing wages. That makes sense, but higher labor productivity and other factors may offset this relationship, so the model is not as straightforward as it seems. Wages need to grow faster than productivity in order to have inflationary effects. In 1968, this negative relationship was revisited by Milton Friedman and inflation expectations were included into the formula. Since then, a substantial volume of economic research has occurred, but in short, the underlying idea is that individuals and businesses incorporate inflation expectations into their demand for money. As an illustration, if you expect prices to increase 3% in the coming year, you will likely try to get your salary increased by at least that amount. You might be wondering what the interest rate has in common with these variables and will note we avoided all the formulae in this explanation. To make the case simple, inflation expectations are adjusted in this model depending on what truly happens in the market. The model will set up an interest rate level that will match the expectations of money demand, based on inflationary expectations and thereby impacting the level of prices. In this context, unemployment is used as what economists call an exogenous variable (comes from outside the model). Other variables, such as inflation, are endogenous (originate from within the model) because they are manipulated to verify that the desired result is obtained. What has been stated with the latest Fed announcement is that unemployment will now be included in modeling at the 6.5% level. In mathematics, that means a third formula has been introduced to account for behavioral features. The implications of doing this could be material, because solving this system of equations means providing information about the relationship between prices and unemployment. This said, the announcement does not change the current methodology because the model has been monitoring levels of unemployment closely all along (through what is called the dual mandate). The new communication is different because it sets a hard goal of 6.5%, thereby confirming interest rates will be at low levels until this target is reached. The concern for community bankers at this time should be that interest rates are to remain at their low levels in the near term. As such, banks will focus on loan growth (especially to small businesses), which in turn aids employment and grows GDP.

BANK NEWS

M&A

Nationstar Mortgage will acquire $215B in residential mortgage servicing rights from Bank of America (about 50% GSE and 50% private label) for an undisclosed sum. The move gives Nationstar 1.3mm new customers.

M&A

Walter Investment Management will buy the $70B residential mortgage servicing platform of MetLife for an undisclosed sum. Walter also agreed to buy about $93B of residential servicing assets from Bank of America.

M&A

Continuing the consolidation trend in investment banking, Houlihan Lokey said it has acquired Milestone Advisors for an undisclosed sum, tripling the size of its financial services group. Houlihan plans to expand its focus on bank M&A, capital raising and other investment banking activities, as it sees ongoing consolidation in the sector in the coming years.

SFR Lending

Through the first 9 months of 2012, Wells Fargo accounted for 30% of all new mortgages, followed by JPMorgan at 10%. Bank of America fell to 4% (down from 20% in 2009).

Settlement

Ten large U.S. banks agreed go pay $8.5B under the Independent Foreclosure Review (IFR) to settle charges of foreclosure abuses. The banks will pay $5.2B in mortgage assistance and $3.3B in direct payments to wronged borrowers (related to improperly seized homes).

Another Settlement

Bank of America will pay FNMA $3.6B to resolve home loan repurchase claims, plus pay another $6.75B to repurchase residential mortgages sold to FNMA.

Video ATMs

NCR said it expects the Top 10 U.S. banks to pilot technology allowing customers to interact with live offsite personnel through video conferencing on an ATM in 2013.