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Waiting for the Fed

April 3—Many market observers expected interest rates to begin rising in 2014, but it did not happen. This sustained period of low interest rates almost certainly will end in 2015, but the question of timing remains open. Key factors that the Fed must consider:

Employment. Payroll employment has increased by an average of 239,000 per month for the past six months, a rate consistent with a healthy, growing economy. That number fell to a disappointing 126,000 in March. Whether that drop was an anomaly attributable to the cold, snowy winter in much of the U.S. or a signal that the economy is losing steam remains to be seen.

Unemployment. In March Fed officials suggested that when the unemployment rate reaches the range of 5.0% to 5.2%, the economy will be at "full" employment, with stable inflation and plentiful jobs. We are very close to that level already. However, that formulation does not take into account the long-term joblessness that has marked this particular downturn. The labor force participation rate edged still lower in March, to 62.7%, a level not seen since the Reagan administration.

Average hourly earnings. Wages have not gained, even as unemployment has fallen. In March earnings rose just 0.3%, only a bit above February's 0.1%. One school of thought posits that higher-paid baby boomers are leaving the work force, bringing down the average. A sign of a possible earnings pickup: Both Wal-Mart Stores and McDonald's (for its company-owned restaurants) recently announced wage increases well above the rate of inflation.

Inflation. The Fed has announced a target inflation rate of 2.0%. Core inflation in February was 1.6%, approaching the Fed's target. On the other hand, low gasoline prices have tamped down inflation, and that effect may ripple through the economy. Gas prices traditionally rise as the summer driving season approaches, but oil inventories are very high at present, with little unused storage available for the surpluses being produced around the world.

The Fed may act on raising interest rates as early as June, provided economic growth looks stable.

Housing

Housing prices still are rising, though more slowly than before. In the 12 months ending with January 2015, home prices rose 4.5%, according to the Standard & Poor's/Case-Shiller Home Price report. In January 2014, that figure was 10.5%. Home prices are still rising about twice as fast as wages.

The rate of increase is made possible by low mortgage interest rates, which have declined to about 3.7% from 4.4% a year ago. *The Wall Street Journal* noted that if home prices rise an additional 5% and mortgage interest rates go up one percentage point, the average monthly mortgage payment would rise 18%. That would put home ownership out of reach for many.

College debt

Home ownership levels already have fallen among recent college graduates. A number of factors are involved, including a possible increased preference for rental housing, avoiding the major commitments that come with home ownership. Federal Reserve governor Lael Brainard voiced additional concerns at a recent conference. Those who graduated during the Great Recession faced a poor job market at the same time as they had large amounts of student debt. Many were forced to take jobs for which they were overqualified, and many found no work at all. Even though the employment situation has improved, it may take a decade or more for this cohort to get back "on track" in their career earnings.

"If the decline in homeownership among young people proves persistent, the implications for asset building for the future could be of concern, since homeownership remains an important avenue for accumulating wealth, particularly for those with limited means," she concluded.

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