The U.S. Labor Market

– Uniting the Market and The Fed –

A Shift from Inflation

Recent inflation data has shown continued moderation, giving the Fed greater confidence that it is heading sustainably towards the 2% goal. This, however, has been accompanied by softer labor market data and has prompted Fed officials to shift their focus to the employment portion of their dual mandate, highlighting the risks of keeping their policy rate restrictive for too long despite leaving the Fed Funds target unchanged at their most recent meeting. After a softer than expected Nonfarm Payrolls (NFP) print for July, markets have undergone a dramatic shift in narrative to that of the Fed now being behind the curve and economic weakness just over the horizon. While we acknowledge labor markets are softening, we do not see the most recent data as a rational justification for the magnitude of the market correction and see opportunities to actively manage through the volatility.

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Bottom Line:

Given the heightened focus on labor market conditions and away from inflation concerns by both markets and the Fed, we have become increasingly attentive to the underlying fundamentals as part of our macro research process. Government data as well as individual company commentary are blended in a holistic approach to develop our thoughts on the current employment situation.

Our view remains that labor market conditions are normalizing from extraordinary circumstances post-COVID but are not in a state that should warrant extreme fear, or the aggressive monetary policy action currently priced in by markets. Data across the board does indicate that the job market is softening and likely warrants policy normalization actions by the Fed given softening inflation. However, the degree to which this is priced in by markets is now more indicative of recession fears than a policy adjustment. Based on the recent data, we believe a rate adjustment is the likely path going forward but the aggressive rate cuts predicated by current market expectations seem too aggressive.

We have maintained a defensive risk posture within portfolios with a focus on increased liquidity to take advantage of volatility like the recent bout in markets. We believe our active management process and optionality in portfolios will allow us to take advantage of the recent re-rating of expectations within markets.

Labor market conditions in the U.S. were extremely tight in the post-pandemic recovery, with record demand and suppressed supply creating conditions conducive to strong employment gains. Since then, NFP gains have been continually moderating on a 3-, 6-, and 12-month rolling average after robust additions in 2022 and 2023, indicating that labor markets are cooling, and job growth has been on a consistent downward trend but have not yet reached concerning levels. JOLTS indicate a similar theme, highlighting that job openings per unemployed worker have returned to levels just prior to the onset of the pandemic. Both initial and jobless claims have been on a consistent upward trend, but off an extremely low base and still in line with a generally healthy economy. The ISM employment indices paint a slightly mixed picture, with manufacturing continuing to be weak, but services (which constitute a much larger portion of the economy) showing slight expansion. Holistically, the data points to an employment situation that is softening but not currently extremely weak.

The most recent NFP print, however, proved to be a catalyst for a marked re-rating of Fed cut expectations to greater than 100bps through the end of the year. A sizeable headline miss (114k additions vs. 175k consensus) and unexpected rise in the unemployment rate to 4.3% (triggering the Sahm rule) sparked fear in risk markets and shifted the narrative to one of the Fed being behind the curve and economic weakness on the horizon. While the recent data certainly suggest that the labor market is cooling, there are a few nuances to the report that indicate labor market conditions may not be as dire as markets are interpreting.

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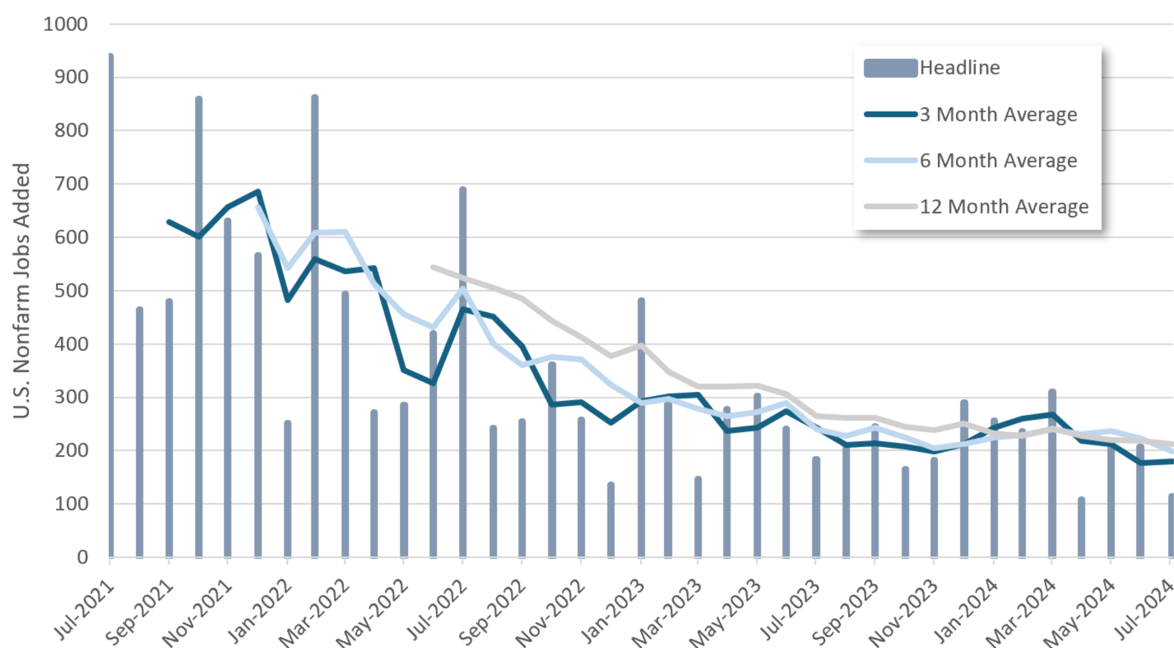


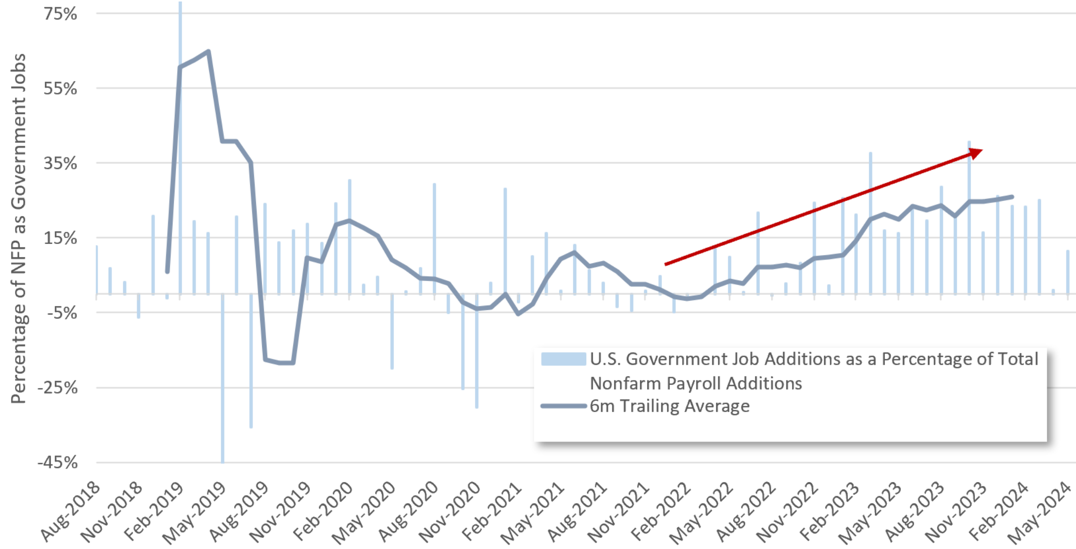
Smith Capital Investors, Bloomberg (8/2/2024)

U.S. Employees on Nonfarm Payrolls Change m/m = NFP TCH Index

First, hurricane Beryl hit Texas on July 8th during the reporting period, and despite the BLS saying it had “no discernible effect” on the data, 436k people in nonagricultural jobs were unable to work due to inclement weather. This compares to a historical average of 32k for July. Another dynamic we witnessed is the impact of immigration and increases in the overall labor force and participation rate putting upward pressure on the unemployment rate rather than a concerning rise in full-time layoffs. Temporary layoffs drove the rise in unemployed workers rather than permanent job losses, which can be a precursor to a downturn but not necessarily indicative of one currently.

There may be some noise in the most recent print that amplifies the negative optics of the current employment situation, but overall, the labor market is not showing the kind of material collapse which would warrant the aggressive Fed policy response implied by markets. Powell highlighted that policy rationalization will be the likely path for the Fed beginning in September, but this does not align with market expectations 50bps of cuts by September followed by 75bp in additional cuts through the end of the year.

U.S. Government Job Additions as a Percentage of Total Nonfarm Payroll



Smith Capital Investors, Bloomberg (8/2/2024)

U.S. Government Job Additions as a Percentage of Total Nonfarm Payrool Job Additions = ECAN56JA Index / NFP TCH Index

Another trend that our team has discussed internally, and has been highlighted by various market participants, is the increasing share of government job additions within the total NFP headline. The chart above shows that government jobs, as a percentage of total NFP headline, have been consistently trending upward from 2022 to 2023. Although it is largely a function of lower headline NFP (private sector slowing hiring on lower growth expectations) while public sector job additions remain relatively unchanged. This, along with the fact that recent revisions to headline employment have been broadly negative, underscores the potential fragility of the recent job gains but doesn't likely warrant the extreme reaction by markets.

We view the recent market volatility as a disconnect from reality and see this as an opportunity to execute on our active management strategies.

Let's keep talking!

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