Perspectives

SEPT 2024

Keep Your Eye on the Labor Market

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The Fed turned the page and began lowering interest rates with an outsized 50 bp cut at its September FOMC meeting. While Chairman Powell described the risks to achieving the Fed's dual mandate goals of maximum employment and stable prices as balanced, the market's reaction to Powell's press conference seemed to reflect anxieties that the labor market is now the chief concern and the Fed's larger rate cut was perhaps a result of not only foresight but fear.

Along with the rate cut decision, the Fed released its quarterly Summary of Economic Projections. In addition to the closely watched dot plot, FOMC members reported expectations for the unemployment rate to end the year at 4.4%, up from the 4.2% reported in August and 1% higher than the post-pandemic low of 3.4% in early 2023. Based on the median 2025 projection, Committee members expect the unemployment rate to remain at 4.4%. While such a move could still support a soft landing for the economy, it would be historic. Looking back over the last 75+ years that the Bureau of Labor Statistics has been collecting employment information, unemployment has never increased by as much as projected without continuing even higher and triggering a recession.

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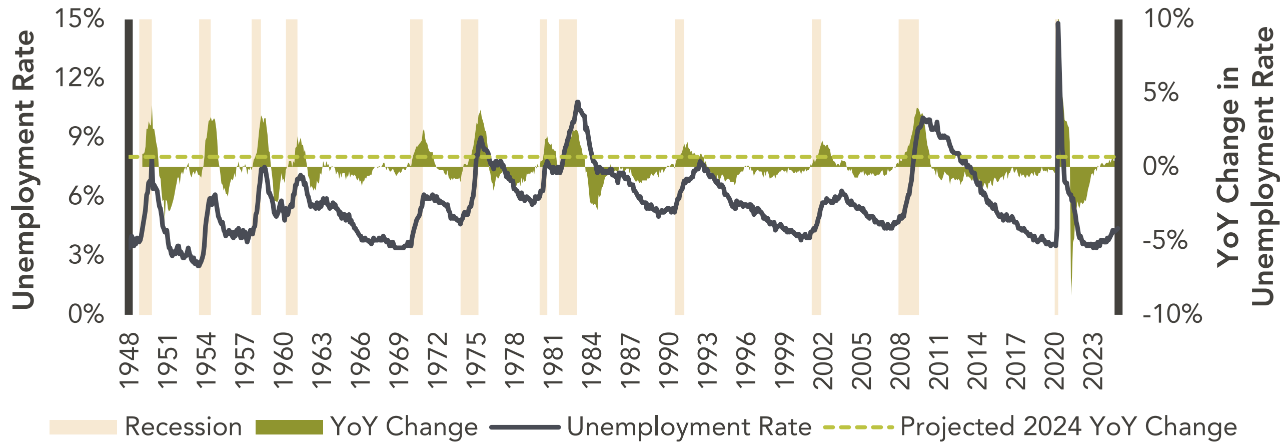
Exhibit 1: Historically, increases of this magnitude over a 12-month period have further escalated and triggered a recession

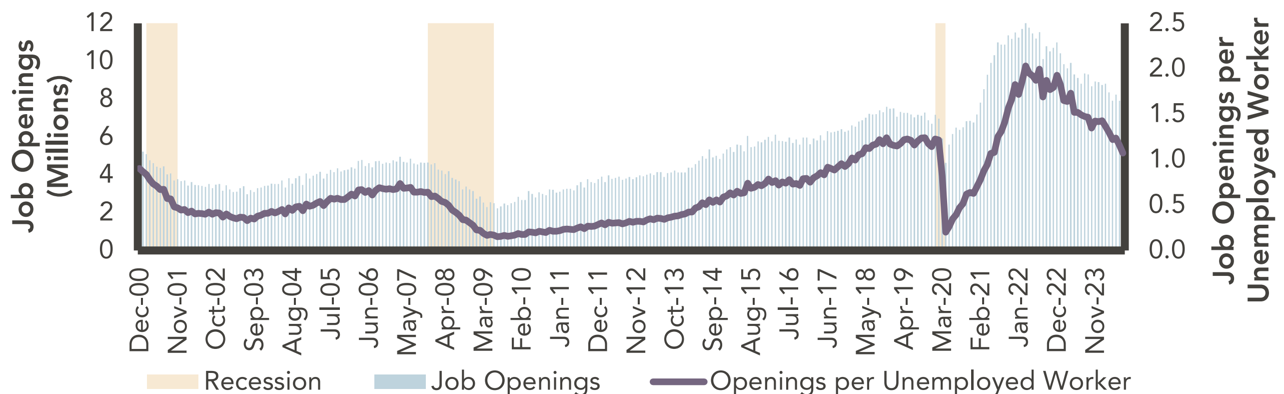


Source: Bureau of Labor Statistics (BLS), National Bureau of Economic Research (NBER), Federal Reserve Bank of St. Louis as of September 19, 2024. September 2024 – December 2024 projections based on the Federal Open Market Committee's Summary of Economic Projections released September 18, 2024.

The rationale behind the data is that unemployment can be contagious and have a snowball effect. As individuals are laid off, their spending ability and demand falls, negatively impacting economic growth and leading to further layoffs. Moreover, sentiment and expectations can exacerbate the effect. As individuals see their friends, family, and colleagues being laid off, they may proactively pull back on their own spending, leading to a self-fulfilling negative feedback loop.

As always when we consider historical precedent, we look for what could be different this time. And this time, a sharp increase in the number of job openings is a new dynamic to consider. Labor market volatility as a result of COVID — first the spike in job losses, followed by a sharp rebound in demand for workers as the economy reopened, mixed with a wave of early retirements — led to a historically tight labor market. The number of job openings per unemployed worker, as shown in Exhibit 2, peaked in early 2022 at more than 2.0. Amid both supply and demand impacts from increased immigration and higher rates, this ratio began to normalize, and at 1.07 as of July 2024 now reflects better balance in the labor market. While an integral component of reducing inflation up to this point, less slack in this metric going forward could mean that further weakening would instead come in the form of outright layoffs, having a bigger impact on the spending snowball effect.

Exhibit 2: Excess job openings that contributed to the tightness in the labor market have corrected back to more normal levels



Source: Bureau of Labor Statistics (BLS), National Bureau of Economic Research (NBER), Bloomberg as of September 19, 2024

As the Fed remains data dependent in considering the pace of additional rate cuts, so will the market. Both the early August equity rout and smaller market correction earlier this month followed disappointing jobs reports, with hiring numbers being revised lower and missing expectations. Further bouts of heightened market volatility could be in store as labor market data points continue to shift market probabilities between a soft landing and something less favorable. While not the only driver of market volatility on a go-forward basis, labor market data bears watching as the coming months play out.

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