GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—October 11th, 2022

Investors are desperately searching for signs the Fed would shift away from its aggressive rate-hiking campaign and adopt a gentler approach towards curbing inflation. For a while this week, hopes ran high that evolving developments might encourage the Fed to "pivot" in that direction, spurring an astonishing two-day rally in stock prices and decline in bond yields. The Labor Department's JOLTS report revealed a marked slowing in job postings, suggesting the job market was loosening up, and various surveys indicated that supply bottlenecks were thawing, which, combined with weakening global demand, were leading to easing price pressures. Despite these encouraging signs, those hopes ran into stiff pushback by Fed officials who were adamant in multiple statements this week that the task of bringing inflation under control was far from done.

Most of the public comments by policymakers came before the all-important jobs report was released on Friday. Had the report provided clear-cut evidence that previous rate hikes were taking a serious toll on the job market and, importantly, slowing wage increases, investors might have taken the Fed's assertions in stride, noting that it has a history of backtracking in the face of economic adversity. But neither the earlier encouraging economic data nor the September jobs report provided reason enough for the Fed to flip the script, at least in the near-term. The next policy-setting meeting is scheduled for November, and we still expect the confab to deliver another jumbo-sized 0.75-percentage point rate increase, the fourth consecutive hike of that size. That said, speculation the Fed might go even bolder – leaping to a full 1-percentage point increase – suggested by some hawkish commentators now seems highly unlikely.

From our lens, there was nothing shocking about the September jobs report. At the margin, it portrayed a labor market that was a tad hotter than expected, but also confirmed perceptions that conditions are easing a bit. The economy generated 263 thousand new jobs last month, almost spot-on with Wall Streets forecast of a 255 thousand gain. The 8 thousand overshoot is nothing to write home about; indeed, the 263 thousand payroll increase is actually the smallest since April of last year, and momentum is losing steam as the 3-month average increase slipped for the second consecutive month. As expected, most of the job gains were in the service sector (244 thousand) reflecting shifts in consumer spending away from goods as the economy continues to reopen from Covid lockdowns.

Hence, the strongest job gains were in leisure and hospitality, which added 83 thousand workers, and in education and health services, which expanded payrolls by 90 thousand. On the goods side, manufacturing jobs increased by a respectable 22 thousand and construction firms added 19 thousand workers. More than a third of the manufacturing jobs were in the auto industry, where production is ramping up as demand remains strong and component supplies, such as computer chips, are becoming more available. In construction, the entire gain was in the nonresidential sector, offices and commercial space, as residential construction is sagging in line with the collapsing housing market. Overall, the job gains were broad based, as almost 61 percent of industries expanded payrolls in September.

Importantly, all job losses from the pandemic recession in 2020 have now been recovered, and then some. With the latest gain, along with revised figures to previous months, nonfarm payrolls are 514 thousand above the pre-pandemic level. The recovery of 22 million jobs in such a short time span is nothing less than remarkable. Still, not all industries have caught up. The biggest laggard is in leisure and hospitality where more than 1 million workers are still missing. Not surprisingly, workers in this sector are among the lowest paid, despite getting the fastest wage increases since the pandemic, and are also among the most vulnerable to health-related risks, since most are in face-to-face contact with customers. Conversely, professional and business services now employ more than 1 million workers than they did just before Covid hit. This sector is not only among the highest paid, but also offer workers more job flexibility, such as the ability to work remotely from home.

The headline reading on job growth is, in itself, evidence that the labor market is still running hotter than the Fed would like. Although the 263 thousand increase in nonfarm payrolls last month does represent a slight slowing, it is still considerably stronger than normal. In 2019, the year leading up to the pandemic, the economy created an average of 164 thousand jobs a month. The ongoing strong demand for workers, meanwhile, continues to put upward pressure on wages, something the Fed closely monitors as a key source of underlying inflation. In September, average hourly earnings increased by 0.3 percent for the second consecutive month, which encouragingly, did lower the annual increase to 5.0 percent from 5.2 percent. However, that's still well above the pace the Fed wants to see to bring inflation down to its 2.0 percent target. Even assuming an optimistic 1.0 percent increase in productivity, that would still produce a labor cost increase of 4 percent that companies would either need to cover the through price increases or accept lower profits.

Perhaps the biggest disappointment in the eyes of the Fed is in the companion household survey of labor conditions, in which the unemployment rate fell to 3.5 percent from 3.7 percent, matching the lowest level in nearly 50 years. Nothing is more indicative of labor market tightness than the unemployment rate and the fact that it is falling rather than rising hardly suggest that the job market is cooling off. Worse, the decline in the unemployment rate occurred for all the wrong reasons. Keep in mind that the Fed would like to see the supply of labor increase, as the increased competition for jobs would reduce pressure on employers to jack up pay packages to fill open positions. But not only did the number of unemployed workers fall in September, so too did the labor force. Hence, the labor force participation rate slipped to 62.3 percent from 62.4 percent, following an encouraging leap of 0.3 percent in August. The rate stands well above the 61.4 percent low hit in the immediate aftermath of the 2020 recession but is still more than a full percentage point below the pre-pandemic level of 63.4 percent.

It's unclear why workers are remaining on the sidelines. To be sure, a major reason the participation rate is lower than before the pandemic is simply demographic trends, as the population is aging and spurring increasing retirements. But the prime-age segment of the population – the 25-54 age group – is also missing workers, as the participation rate among that cohort stands a half-percent below its pre-pandemic level. Many believe that reports of labor shortages are giving workers a sense of confidence they can get a job whenever they need one and decide to hold off until their funds run out or the job offerings do not require them to commute to an office. Unless prime-age workers change their minds about seeking a job, there are only a few other options to juice up the supply of labor. Older workers could be coerced to come out of retirement and rejoin the workforce, something that is happening to some extent. Or immigration policies could be relaxed and open the door for this historically vital source of new workers to enter the labor stream. Recent studies estimate that restrictive immigration policies have lowered the size of the labor force by 1.7 million below what it otherwise would be.

Again, it would be a mistake to view the latest jobs report as a scary inflation-amplifying development that should spur the Fed to ramp up its rate-hiking efforts. The headline fall in the unemployment rate will no doubt capture headlines and suggest that the labor market is overheated, requiring stronger central bank intervention to keep wage growth in check. We doubt, however, that the Fed will be swayed into changing its present course by the latest jobs data. Despite the headline reading, it's important to recognize that overall job growth is slowing and job openings, as noted earlier, are being cut – and cut dramatically. In August, openings fell by an historic 1 million according to the JOLTS report, although they still far exceed the number of unemployed workers. In fact, the strong pace of job growth may reflect in part efforts by companies to backfill job openings with workers that were difficult to recruit before. If so, that might be a sign labor shortages are easing a bit.

To be sure, wage growth is still strong and applying pressure on businesses to raise prices. But there is evidence that wages are less a cause of rising prices than a reaction to price changes. Hence, if price increases slow, so too will wage increases, as workers feel less urgency to keep up with inflation. On many fronts, inflation is starting to cool, thanks to weakening global demand for commodities, easing bottlenecks and weakening business pricing power. The Fed will probably not ease up its rate-hiking campaign until it sees at least several months of back-to-back slowing in price gauges. So far, that has not materialized and next week's release of the consumer price index – the last before the next Fed meeting in November, will not show enough of a cooling to make a difference. As noted, we expect another .75-percntage point hike at the upcoming meeting followed by another 50-point increase in December. By next year, inflation should be on a sustained retreat, allowing the Fed to pause and assess the impact the most rapid rate hikes since the early 1980s is having on the economy.

FINANCIAL INDICATORS

INTEREST RATES	Oct 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.37	3.27	2.96	0.04
6-month Treasury bill	4.09	3.95	3.55	0.05
3-month LIBOR	3.83	3.74	3.24	0.13
2-year Treasury note	4.31	4.28	3.56	0.27
5-year Treasury note	4.15	4.07	3.40	0.93
10-year Treasury note	3.89	3.83	3.32	1.46
30-year Treasury bond	3.85	3.78	3.45	2.03
30-year fixed mortgage rate	6.66	6.70	5.89	3.01
15-year fixed mortgage rate	5.90	5.93	5.16	2.28
5/1-year adjustable rate	5.36	5.30	4.64	2.48
STOCK MARKET				
Dow Jones Industrial Index	29,296.39	28,725.51	32,151.31	34,326.46
S&P 500	3,639.66	3,585.62	4,067.36	4,357.04
NASDAQ	10,652.40	10,575.62	12,112.31	14,566.70
COMMODITIES				
Gold ($ per troy ounce)	1,701.80	1,668.30	1,727.60	1,761.30
Oil ($ per barrel) - Crude Futures (WTI)	93.20	79.74	86.10	75.75

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (September)	50.9	52.8	52.8	53.5
ISM Services Index (September)	56.7	56.9	56.7	56.4
Nonfarm Payrolls (September) - 000s	263	315	537	360
Unemployment Rate (September) - Percent	3.5	3.7	3.5	3.6

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