Weekly Economic Update—March 6th, 2023

All eyes are diligently focused on next Friday's employment report, the first significant reading for February, and not only for its intrinsic importance as an indicator of the job market's health. It will also give us a sense of whether January's surprising burst of hiring was an outlier, or a true gauge of the remarkable vigor shown in last month's report. We, like the consensus, expect a sharply reduced pace of job growth for the month, but it will be interesting to see if there are any major revisions to the January gain in payrolls, which the initial estimate put at an eye-popping 517 thousand, more than double expectations. That report triggered a profound reassessment of the economy's fundamental strength among investors and the Federal Reserve, setting in motion a dramatic shift in financial market trends. Since that report, which has been reinforced by other hard data revealing more muscular activity than thought, market yields have surged and stock prices have slumped, mainly in response to expectations of a more aggressive Fed policy.

But while the hard data on jobs, incomes and consumer spending are portraying a surprisingly resilient economy, one that so far has not buckled under the Fed's harsh rate-hiking campaign, the soft data are showing just the opposite. In most recent surveys of households and businesses, the message coming across is that the economy is in precarious shape or expected to be soon. Similarly, the hard inflation data, while cooling, remains hotter than expected and signals the need for a firmer dose of monetary tightening to bring it down to an acceptable rate. But here too the soft data are showing greater progress on the inflation front, arguing for more patience rather than tougher growth-retarding measures. It is not unusual for the soft and hard data to diverge and, unsurprisingly, the hard data tends to have a greater influence on the financial markets and Fed policy. After all, the accepted mantra underpinning most decisions is, "watch what people do, not what they say."

The main argument against hard data is that they are mostly backward-looking and can prompt misguided policy decisions when conditions are rapidly changing. For example, the hard data paint an unambiguously tight job market. The Labor Department reports that there are far more job openings than job seekers, the unemployment rate and claims for jobless benefits are at historically low levels and companies are expanding payrolls at a breakneck pace. But the unfilled job openings data may well exaggerate the extent of labor shortages. Private recruitment firms, such as Indeed and ZipRecruiter, report that new job listings are falling rapidly. What's more, the elevated level of job openings may mask a proactive decision by companies to fill positions more slowly, reflecting uncertainty over sales prospects. This slow-walking of filling positions is the mirror image of the sustained low level of claims for jobless benefits. Simply put, companies are reluctant to lay off workers, fearing rehiring difficulties when the economy rebounds.

Meanwhile the unemployment rate has become a less reliable indicator of job market tightness due to the increase in workers that have dropped out of the labor force. Demographic forces, with baby boomers reaching retirement age, explain a good part of that trend, but the participation rate among prime-age men, 25-54, is nearly a full percentage point below its pre-pandemic peak. Since February 2020, the number of people not in the labor force has increased by 5 million, dwarfing the 1.4 million increase in the labor force. Finally, the hard data on payrolls are also coming under a cloud because the Labor Department is getting far fewer responses from companies to its questions regarding payrolls and job openings. The response rate for the payroll data has fallen to just 44 percent in December from 60 percent in January 2020. The retreat for the JOLTS data, which includes job openings, has been even more dramatic, plunging to only 31.1 percent from 58.4 percent.

With such a low response rate, a lot of guesswork is involved in the first estimate of date releases. That's one reason economists are keen on seeing if the January gangbusters payroll surge will be revised down in the February report, when more information will be available. Even then, a firm estimate for the month will not be on hand until the annual benchmark revisions are made in March, which are based on more comprehensive state unemployment insurance tax reports filed by employers. In the last benchmark revision, 506 thousand workers were added to the payroll level in March, but that covered a year of robust economic growth, fueled by stimulus payments and near zero interest rates.

For the most part little guesswork is involved in soft-data surveys, as the pollsters have firmer ties to respondents and receive a much higher response rate from questions. The Institute for Supply Management does not disclose the number of questionnaires it receives back from its monthly surveys of manufacturers and service-sector companies, but comparable trade groups and associations generally report a response rate of over 80 percent from members. And while these surveys are considered "soft data" they do convey real-time events reported by the respondents. One question that is integral to the inflation narrative asks whether a company is paying more or less for inputs than a month ago. The results are expressed as a diffusion index, i.e., anything over 50 means that more companies are paying more than less. That's clearly still the case, but the share of companies doing so is falling more rapidly than depicted by conventional price indexes (which, themselves, are based on dodgy surveys).

Interestingly, this week's ISM report that showed an uptick in prices paid by manufacturers in February elicited a negative response in the bond market, sending yields higher. But the move nudged the subindex to just over the 50 threshold, almost spot-on with where it stood just before the onset of the pandemic. Price pressures are more pronounced in the service sector, which accounts for a larger share of the economy's output and relies more heavily on labor than manufacturers. But here too, the share reporting higher prices is falling dramatically. Perhaps the most striking example of backward-looking hard data can be found in the CPI, where surging housing costs is the major catalyst driving up the index. But as is the case with job openings, new leases are being signed at much lower rents than negotiated six months or a year ago.

Make no mistake. The economy is riding more momentum and inflation has been far more persistent and elevated than expected in the opening months of the year. Even if the January payroll report is revised down by, say, 50 percent from the original estimate – an unlikely outcome – jobs would still be growing at more than double the pace consistent with a cooling economy. A more balanced job market would see payrolls just keeping up with population growth, which translates into about 100 thousand a month. We expect that pace to be reached late in the second quarter, before outright job losses start to emerge in the second half of the year when the economy likely heads into a mild recession. Underscoring that prospect, the economy's main growth driver, consumer spending, should start to roll over in response to the dramatic increase in borrowing costs, dwindling savings accumulated during the pandemic – particularly among lower-income households – and slower income gains as the job market cools.

To be sure, incoming hard data on consumers hardly suggests they are poised to pull in their horns. Like the jobs report, households went on a stronger-than-expected spending spree in January and the robust payroll increase injected a good deal of muscle into weekly paychecks. But households are likely to rebuild savings with those funds as a precautionary measure to guard against an adverse turn of events. Granted, consumer confidence held up well according to the Conference Board's February survey released this week. But that resilience reflects households' perception of current conditions, including the abundance of available jobs. Asked about the future, things look far less rosy, including expectations regarding job prospects. Just as most hard data are backward-looking, we view the soft data as presented in the surveys to be forward-looking indicators. The Fed, of course, is resolutely data dependent, relying mostly on hard data. The risk is that it responds to past events that may be in the midst of cooling rapidly, applying more growth-retarding policy tightening than is warranted by economic conditions prevailing over the next several months.

FINANCIAL INDICATORS

INTEREST RATES	Mar 3	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.85	4.82	4.62	0.33
6-month Treasury bill	5.13	5.11	4.78	0.64
3-month LIBOR	4.99	4.96	4.81	0.58
2-year Treasury note	4.87	4.80	4.08	1.49
5-year Treasury note	4.26	4.21	3.66	1.64
10-year Treasury note	3.96	3.95	3.52	1.73
30-year Treasury bond	3.88	3.93	3.62	2.16
30-year fixed mortgage rate	6.65	6.50	6.09	3.76
15-year fixed mortgage rate	5.89	5.76	5.14	3.01

STOCK MARKET				
Dow Jones Industrial Index	33,390.97	32,816.92	33,926.01	33,614.80
S&P 500	4,045.64	3,970.04	4,136.48	4,328.87
NASDAQ	11,689.01	11,394.94	12,006.95	13,313.84

COMMODITIES				
Gold ($ per troy ounce)	1,862.70	1,818.00	1,877.70	1,974.90
Oil ($ per barrel) - Crude Futures (WTI)	79.86	76.45	73.27	115.00

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (February)	47.7	47.4	48.4	48.9
ISM Services Index (February)	55.1	55.2	49.2	54.2
Consumer Confidence Index (February)	102.9	106.0	109.0	104.7