GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—October 10th, 2023

In a world full of surprises, the monthly employment report on Friday ranks near the top. The economy generated far more jobs than expected in September and initial estimates for previous months were revised higher. The upward revisions to previous reports break a long string of downward revisions that occurred in every month this year through August, the longest such stretch since the 2008-09 Great Recession. More broadly, the September jobs report suggests to some that the labor market is getting a second wind, staging a rebound following months of slowing payroll gains. Importantly, it also suggests that the Fed has more work to do, if it clings to the notion that only a weakening job market can further its objective of wrestling inflation down to its 2 percent target.

No doubt, the financial markets – which abhors surprises – will spend the next few trading days processing the latest jobs report. The knee-jerk reaction in the bond market was expected: yields jumped as the headline readings point to a more hawkish Fed than otherwise to bring inflation to heel. That initial response is understandable. The 336 thousand increase in nonfarm payrolls last month was double the expected gain of 170 thousand, even as 119 thousand was added to the totals for July and August. It was also the largest monthly gain since January and lifted the average increase for the last three months to 266 thousand from 189 thousand in August. While the upward revisions to previous months were all in the government sector, private payrolls also increased strongly in September – by 263 thousand from 177 thousand in August.

That's quite a jolting turnaround that belies widespread perceptions – including by Fed officials – that the labor market was showing signs of softening. Meanwhile, the unemployment rate remained at 3.8 percent, hovering near historically low levels, and a solid 64.2 percent of private industries expanded their workforce, paced by an eye-opening 96 thousand increase in payrolls in the leisure and hospitality sector. That was followed by solid increases in health and social services (65.9 thousand), business and professional services (21 thousand), retail (19.7 thousand) and manufacturing (17 thousand). The government also added 73 thousand jobs, mostly in education, although the strength there may have been skewed by seasonal adjustment problems that typically occur around the start of the school year.

While it is tempting to view the latest jobs report as a sure-fire precursor of more Fed rate hikes and stubborn inflation, a deeper dive beneath the headlines portrays a more benign picture of emerging developments. Forget for the moment that initial estimates are subject to large revisions. Given the sizeable upward adjustments to the payroll data for July and August, the September tally could be revised up as well as down. Indeed, the upward revisions to previous months together with the surprising strength in September payroll gain aligns more with the GDP tracking data, which depicts stronger growth in the third quarter than in each of the previous two quarters. Unless productivity unexpectedly jumped, more output requires more workers.

But the good news is that it is not costing businesses more to attract workers. Average hourly earnings increased by a mild 0.2 percent for the second consecutive month and by 4.2 percent over the past year. The year-on-year increase was the slowest since June 2021. Importantly, the slowing growth in wages is gaining momentum. Over the past three months, average hourly earnings increased at an annual rate of 3.4 percent, which if sustained would be consistent with the Fed's 2 percent inflation target after adjusting for 1.5 percent productivity growth. Even more encouraging, the annual rate over the past three months for private sector service workers slipped to 3.0 percent, the weakest since March 2021. This is important because the Fed is laser focused on a so-called super-core group of service prices, which is heavily influenced by labor costs.

From our lens, the September jobs report does not follow the “good news is bad news” script. Sturdy job growth that does not fuel outsize wage increases is a sign that the labor market is coming into better balance, something that the Federal Reserve has been striving for since it started its rate-hiking campaign. Earlier in the post-pandemic recovery, the rebound in job growth occurred amid a severe worker shortage that ignited a surge in wage growth to a 5.5%-6.0% pace, which made it very difficult for the Fed to rein in inflation. From the Fed’s perspective, the ideal path towards taming wage growth would be to lure more workers off the sidelines, lifting the supply of labor more in line with demand. Progress on that front has been slow to come, but it is now gaining traction.

The share of prime-age workers, age 25-54, is up to 83.5 percent, the highest in more than 20 years. And despite an aging workforce that is spurring an increase in retirements, the overall labor force participation rate has been rising steadily and, at 62.8 percent, is spot-on with the average from 2013 through most of 2019. Nor is it just people returning to the labor force who had previously dropped out, such as retirees. In recent months, there has been a solid increase in new entrants to the workforce. Simply put, businesses now have a larger pool of applicants to choose from, which in time honored fashion lowers the pressure to lure workers with higher pay packages.

The question is what is spurring the increase in labor supply? One explanation could be that the depletion of excess savings amassed during the pandemic is running out. Clearly, the generous stimulus and other transfer payments that bloated household bank accounts during the height of the Covid crisis allowed many would-be workers to stay on the sidelines. With that savings cushion deflated and better job prospects offering more attractive wages, the incentive to join the workforce is much stronger. For another, the surge in immigration may also be feeding the supply of labor, particularly in low-wage industries such as leisure and hospitality and retail. Not coincidentally, the slowdown in wage growth has been much steeper for nonmanagement workers than for all private sector workers over the past year.

We believe the September jobs report conveys more good than bad news for the economy. The prospect for a soft landing is enhanced if the job-creating engine continues to hum while inflation continues to recede, a combination that was clearly evident in September. In retrospect, the surprising increase in job openings in August reported earlier this week -- that sent the bond and stock markets reeling – may reflect a response by businesses to the expanded supply of labor rather than increased demand for workers. We don’t believe that the September jobs report will prompt the Fed to raise rates again at its November 1 meeting, given the tamer reading on wages. The upcoming CPI report could be the decisive influence in its decision. The rise in market yields following the report probably reflects investor perceptions that the Fed is even more likely to keep rates higher for longer. However, the bond market is taking some of the burden of curbing growth off the Fed’s shoulders, which also relieves it of pressure to raise rates again at the next meeting.

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FINANCIAL INDICATORS

INTEREST RATES	Oct 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.51	5.46	5.46	3.37
6-month Treasury bill	5.58	5.55	5.53	4.09
2-year Treasury note	5.07	5.05	4.97	4.31
5-year Treasury note	4.76	4.62	4.41	4.15
10-year Treasury note	4.79	4.58	4.27	3.89
30-year Treasury bond	4.96	4.71	4.34	3.85
30-year fixed mortgage rate	7.49	7.31	7.12	6.66
15-year fixed mortgage rate	6.78	6.72	6.52	5.90

STOCK MARKET				
Dow Jones Industrial Index	33,407.58	33,507.50	34,576.59	29,296.39
S&P 500	4,308.50	4,288.05	4,457.49	3,639.66
NASDAQ	13,431.34	13,219.32	13,761.53	10,652.40

COMMODITIES				
Gold ($ per troy ounce)	1,844.60	1,864.60	1,942.60	1,701.80
Oil ($ per barrel) - Crude Futures (WTI)	82.83	90.88	87.23	93.20

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM manufacturing index (September)	49.0	47.6	46.4	47.2
ISM services index (September)	53.6	54.5	52.7	52.8
Nonfarm payrolls (September) - 000s	336	227	236	234
Unemployment rate (September) - percent	3.8	3.8	3.5	3.6
Average hourly earnings (September) - % change	0.2	0.2	0.4	0.3

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