GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—December 11th, 2023

It was all about jobs this week, and the deluge of reports did little to change the narrative that labor conditions continue to cool but are far from freezing up. This backdrop is exactly what promoters of the soft-landing scenario are selling to the financial markets and the Federal Reserve. That said, it does appear that the markets have been getting ahead of themselves, pricing in four or five interest-rate cuts by the Fed in 2024. We always felt that the Fed had a higher bar for rate cutting and the prospect that it would pull the trigger so quickly and frequently next year was unrealistic. The data this week, highlighted by Friday's all-important monthly employment report, seems to support our view.

Indeed, following the slightly hotter than expected jobs report on Friday, the markets priced in lower odds that an early rate cut would take place next year. From our lens, that's a sensible shift in perceptions as the labor market is far from displaying enough weakness to warrant a pivot by the central bank, which puts the struggle to wrestle inflation down to its 2 percent target on top of its list of priorities. If anything, the continued strength in wage growth revealed in the November jobs report demonstrates how hard it is to travel the last mile of that journey. That said, there is an important offset that is relieving pressure on employers to pass on higher wages to customers in the form of higher prices. Productivity surged in the third quarter, which lowered unit labor costs and raises hopes that workers can achieve heftier paychecks without stoking higher inflation – a win-win for everyone. However, it is far too early to conclude that the productivity spike can be sustained.

For its part, the Federal Reserve sees a narrow – but widening -- path to a soft landing, one that has eluded policy makers in the past. Historically, wrestling inflation down from unsustainably high levels involved large increases in unemployment that would undermine worker bargaining power and lower wage demands that would translate into reduced demand for goods and services, all of which would undercut the ability of businesses to raise prices as the economy slipped into a recession. To avoid that vicious cycle, policymakers would like to see companies hold on to their workers but slow hiring enough to generate softer wage demands, leading to a gradual cooling of economic activity and lower inflation without sending the economy into a tailspin.

Happily, that virtuous cycle appears to be unfolding. In its more comprehensive Jobs Opening and Labor Turnover Survey (the so-called JOLTs report), released earlier it the week, companies sent out a strong signal that the demand for workers is becoming less intense. Job vacancies plunged by 617 thousand in October to 8.7 million, the lowest since March 2021. Importantly, the ratio of job openings to unemployed workers sank to 1.34 from 1.47 in September. That's still slightly elevated – a level of 1.0 is consistent with a balanced labor market – but it is far below the peak of over 2.0 hit last year and is clearly reflective of weaker labor demand and a slower pace of hiring in the months ahead. The fact that fewer workers are voluntarily quitting their jobs is a sign that workers are also getting that message, making it less likely they will demand outsize wage increases to stay put.

At first glance, the November jobs report suggest that the softening job market depicted in the October JOLTs report did not carry through to November. Payrolls increased by a sturdy 199 thousand during the months, somewhat stronger than the consensus expectations and up from a 150 thousand gain in October. But that headline figure was artificially boosted by the return of 47 thousand striking workers in the auto and entertainment industries, which left the picket lines last month. Indeed, not all of them have returned in time to be included in the Labor Department's survey, so some spillover boost could be expected in December as well. Subtract those UAW and SAG workers from the headcount, and the job gain in November would be close to the 150 thousand increase in September. That's still more than the growth in the labor force, so

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job searchers remain in the driver's seat. Indeed, the unemployment rate fell to 3.7 percent from 3.9 percent, remaining below 4 percent for 22 consecutive months. That's the longest stretch below 4 percent since the 1960s.

Still, the current pace of job growth is well below the 236 thousand average gain over the previous 12 months, so a cooling trend is clearly underway. What's more, revisions have consistently lowered previous estimates of job gains in recent months; this time is no different, as the totals for September and October were revised down by 35 thousand jobs. Not only are job gains slowing, but they are also becoming more concentrated as only 54.8 percent of private industries expanded payrolls last month. That's still a majority, but narrower than the 58.5 percent that were expanding staff on average over the previous 12 months. In November, 167 thousand of the 199 thousand increase in payrolls came from three sectors, leisure and hospitality, education and social services, and manufacturing. The 28 thousand increase in manufacturing jobs was entirely due to the returning 30 thousand striking auto workers.

The good news is that workers are coming off the sidelines to fill open positions, as the labor force increased by a whopping 532 thousand. Importantly, all of them, and then some, found jobs as unemployment fell by 215 thousand, resulting in the aforementioned 0.2 percent lowering of the unemployment rate to 3.7 percent. The labor force participation rate rose to 62.8 percent, matching the pandemic recovery high, with all the increase coming from teens and the over 55 age group, more than offsetting the ongoing wave of retirements that underpins the longer-term trend of declining participation. While higher wages are luring some of these workers off the sidelines, many are returning to the workforce to make ends meet, as inflation and higher borrowing costs are squeezing budgets.

For the most part, the Federal Reserve must be pleased by ongoing evidence that the labor market is gradually, but steadily, cooling. However, the battle to conquer inflation requires more progress on the wage front, which continues to run too hot for the Fed's comfort. Average hourly earnings increased 0.4 percent last month, double the October increase and leaving the gain over the past year at 4.0 percent. That too is cooler than the 5-6 percent increases seen in 2022, but the average earnings data are skewed by the changing composition of low-paying and high-paying jobs from month to month. Other measure, which adjust for the changing mix of jobs, show stronger wage gains, including the Employment Cost Index and the Atlanta Fed Wage Tracker, which is running above 5 percent. Annual wage growth of 3.5% is consistent with a 2% inflation target, and the Fed will need to see most measures approaching that pace to be assured inflation is on a sustainable path back to its target.

In sum, the latest jobs report does nothing to change our view that the Fed is finished raising rates but will be quite patient before lowering them. We think financial markets have been too aggressive in pricing in rate cuts for early next year and expect the policy-setting committee will push back on those expectations at its meeting next week. Our forecast continues to assume the Fed won't lower rates until the third quarter of 2024. To cut rates sooner, we think the Fed would need to conclude that the risks to the economy of keeping rates higher for longer are greater than the risk that progress on inflation stops or is reversed if the Fed lowers rates prematurely. We think it will take several months more of data before the Fed reaches that conclusion.

FINANCIAL INDICATORS

INTEREST RATES	Dec 8	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.38	5.38	5.37	4.30
6-month Treasury bill	5.38	5.36	5.46	4.73
2-year Treasury note	4.73	4.55	5.05	4.36
5-year Treasury note	4.25	4.13	4.67	3.77
10-year Treasury note	4.23	4.20	4.62	3.58
30-year Treasury bond	4.32	4.39	4.74	3.56
30-year fixed mortgage rate	7.03	7.22	7.50	6.33
15-year fixed mortgage rate	6.29	6.66	6.81	5.67
STOCK MARKET				
Dow Jones Industrial Index	36,247.87	36,245.50	34,332.00	33,476.46
S&P 500	4,604.37	4,594.63	4,431.50	3,934.38
NASDAQ	14,403.97	14,305.43	15,608.75	11,004.62
COMMODITIES				
Gold ($ per troy ounce)	2,019.00	2,091.70	1,941.80	1,809.40
Oil ($ per barrel) - Crude Futures (WTI)	71.20	74.78	77.38	71.58

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Services Index (November)	52.7	51.8	53.6	53.2
Nonfarm Payrolls (November) - 000s	199	150	262	186
Unemployment Rate (November) - Percent	3.7	3.9	3.8	3.7
Average Hourly Earnings (November) - % change	0.4	0.2	0.3	0.3
Consumer Credit (October) - Blns of $s	5.1	12.2	-12.4	5.0

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