Economic INSIGHT

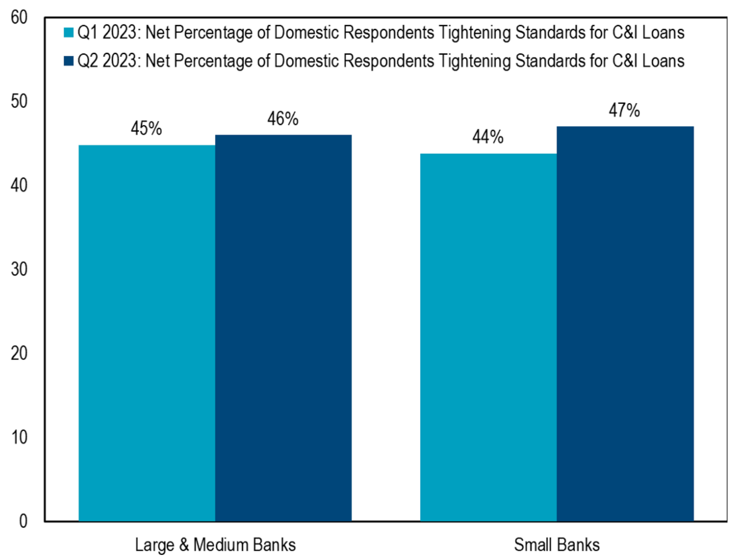
May 15, 2023

Solid Labor Market Data Complicates Fed's Willingness to Pause

Despite the Committee's most recent decision to hike rates for the 10th time in 14 months, the Federal Reserve (Fed) may be poised to take an abrupt turn in policy at next month's meeting. For many investors, the presumption is the Fed, which has taken a wait-and-see approach based on incoming data, will pause its rate increases in June and then implement a series of rate cuts in the second half of the year. If economic data continue to run strong, however, particularly in the labor market, the Fed will have a difficult time justifying holding steady, let alone lowering rates. After all, despite uncertainty in the banking space and unknowns surrounding the debt ceiling, restoring price stability remains – should remain – the Fed's primary focus.

WILLINGNESS TO ASSESS

Acknowledging still-too-high price pressures in the U.S., the Committee indicated in the May Federal Open Market Committee (FOMC) statement its increased willingness to potentially move to the sideline as they assess the evolution of data, lagged effects in monetary policy, and financial market developments. While willing to "do more" as needed, the Committee will take into account various factors "in determining the extent to which additional policy firming may be appropriate." In other words, the Fed is somewhat unclear as to how much – if any – further policy action will be needed to tame wage pressures and more broadly, inflation. This keeps the door open for a potential pause as early as next month, while also not entirely ruling out the possibility of additional tightening.



Source: Federal Reserve Board

*Small banks = annual sales of less than $50M
*Large & medium banks = annual sales of $50M or more

We still have a long way to go to bring down inflation, Federal Reserve Chair Jerome Powell said during the May

Lindsey M. Piegza, Ph.D.
Chief Economist
piegzal@stifel.com

Lauren G. Henderson
Economist
hendersonla@stifel.com

STIFEL

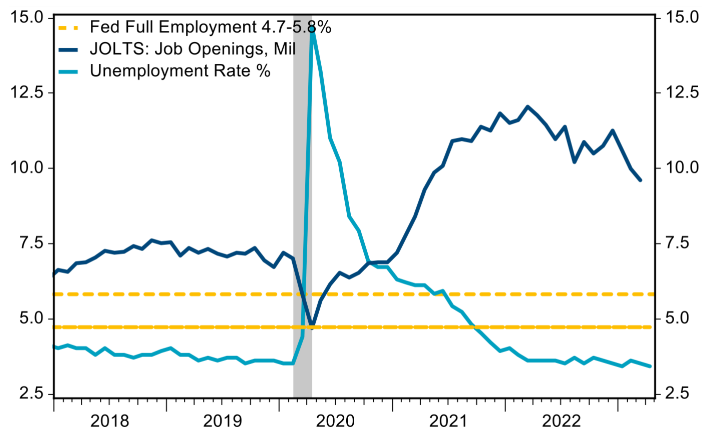
press conference; however, the economy is likely to face further headwinds as a result of earlier policy initiatives and tighter credit conditions. The latter could potentially aid the Committee in its fight against inflation. "Reducing inflation is likely to require a period of below-trend growth and some softening of labor market conditions," Powell stated, offering somewhat of an outline of anticipated conditions to warrant a softer policy approach in the near term.

Future policy action will – and has always been – based on how events unfold with decisions made on a meeting-by-meeting basis. The difference now is the Committee appears less certain as to the direction and extent of policy needed to reach a sufficiently restrictive level as weakness is anticipated to emerge in hiring and the broader economy. As such, the Fed appears increasingly willing to evolve its policy approach from an earlier plan of raising rates while assessing to one of "pause and assess."

WEEEEEAKKKKKNEEEESSSS! WHERE ARE YOU?

On May 3, after hiking the upper bound of the target range to 5.25%, the highest level since August 2007, Powell suggested the Committee may have done enough. "We're getting close [to the terminal level] or maybe even there," Powell said. After all, the latest data appears to support the notion of a slowdown or, at the very least, a loss of momentum in domestic activity, particularly in the labor market. While the labor market remains very tight, Powell noted that some metrics are beginning to come back into balance.

Job vacancies, Powell specifically cited, dropped from a recent peak of 12 million in March of last year to 9.6 million as of the latest February read, a significant 20% decline. Additionally, jobless claims have inched up in recent weeks from an average of 200,000 in January to 240,000 in April amid numerous announcements of sizable corporate layoffs. From household names such as Gap, Meta, Amazon, and Accenture, nearly a quarter of a million job cuts have made the headlines since the start of the year.



Source: Bureau of Labor Statistics/Haver Analytic

Of course, even with these early indications of a possible loss of momentum in hiring, monthly job creation currently remains robust. Two days after the May rate announcement, April nonfarm payrolls far surpassed expectations by jumping 253,000, the strongest monthly gain since January. The prior two months were revised down by a combined 149,000, but even with these revisions, the trend pace of employment remains solid at 285,000.

Payroll strength was widespread across a variety of sectors in April with education and health leading the way with a gain of 77,000 at the start of the second quarter. Leisure and hospitability has also been particularly robust since the start of 2021, reporting

GLOSSARY

AHE – Average Hourly Earnings

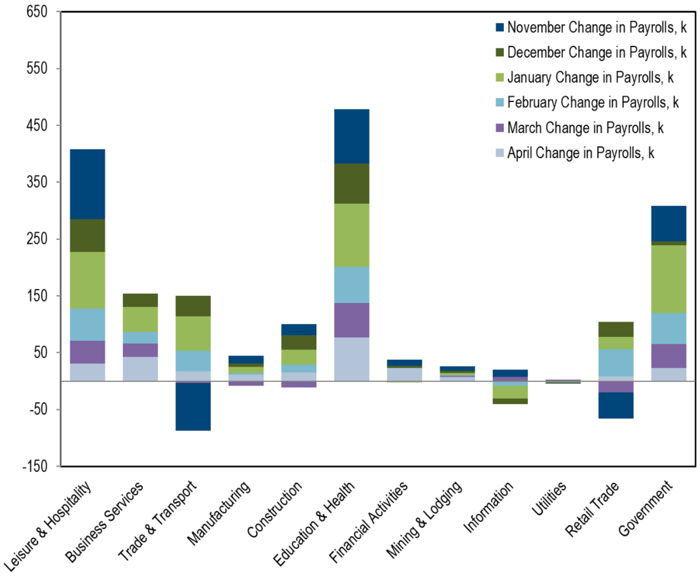
CPI – Consumer Price Index

FOMC – Federal Open Market Committee

YoY – Year over Year

STIFEL

a combined increase of 3 million jobs and reflecting somewhat stable demand for services. Even retail and construction hiring appears to be bucking the broader trend of weakness in goods consumption and housing with positive hiring in April, up 8,000 and 15,000, respectively.



Source: Haver Analytics/Bloomberg

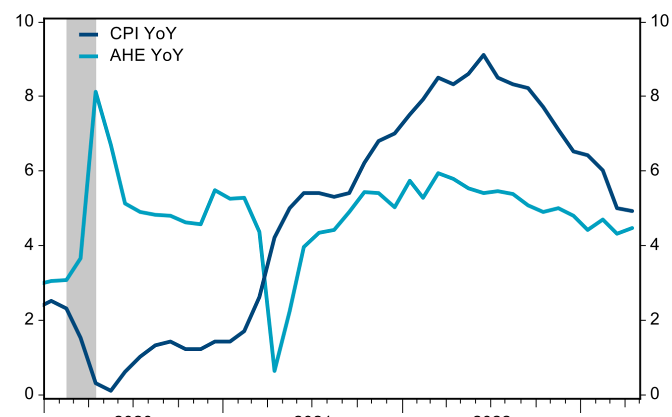
Additionally, with the participation rate steady at 62.6%, the highest since March 2020, the unemployment rate ticked down in April – albeit minimally from 3.5% to 3.4%. Unemployment is at its lowest level since 1969 and fueling an imbalance in labor metrics.

As labor demand substantially outpaces labor supply, businesses are increasingly willing or simply required to pay more for labor to both keep existing employees and attract new workers. As a result, these same businesses are prompted to keep prices elevated to offset higher input costs, continuing the dreaded wage-price spiral and complicating the policy outlook for the Fed.

In April, wages rose 0.5%, gaining momentum from more limited monthly gains at the start of the year. Year-over-year, wage pressures increased 4.4% in the latest report, trending higher from an earlier pace of 4.3% reported in March. Meanwhile, consumer prices rose 4.9% over the same period with core prices up 5.5%, still more than double the Fed's target level.

WHAT IF ...

May's FOMC rate decision was unanimous. June's policy decision, however, is likely far from consensus among voting members at this point. While some officials may be inclined to move to the sideline – at least temporarily – and assess the full impact of an earlier 500 basis points in tightening, the growing attention or weighting for a potential pause will no doubt face fierce debate next month. After all, this seemingly novel adjustment in the Fed's policy directive comes in the wake of a significantly stronger-than-expected pickup in first-quarter growth with real final sales jumping 3.2%, a persistently tight labor market with a multi-decade low unemployment rate, and still-elevated inflation that is more than double the Fed's target rate.



Source: Bureau of Labor Statistics/Haver Analytic

STIFEL

If the relative calm in the markets is maintained, particularly in the wake of an ongoing debt ceiling debate, and if the data remains solid, and if the Fed remains committed to reinstating price stability, there is clearly more work to be done before policy reaches a “sufficiently restrictive” level. The Fed is willing to move to the sidelines, but not if the data suggest otherwise.

Of course, while the Fed will follow the data, the market may be more inclined to shadow a preconceived notion of a return to easy money policy sooner than later. Regardless of the latest read on inflation or the unemployment rate, investors continue to anticipate a pause in June and a significant number of rate cuts over the coming year, perpetuating a growing disconnect between realized policy and investors’ expectations.

Lindsey Piegza
Ph.D., Chief Economist
piegzal@stifel.com

DISCLAIMER

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0423.5647107.1

STIFEL