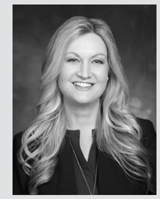
August 7, 2023

Economic
INSIGHT

Hard Landing "Deferred," Not Avoided: Strength in the Labor Market Indicates Need for Further Policy Action, Increasing Odds of – Eventual – Downturn



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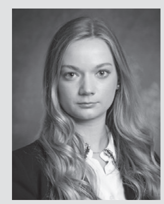

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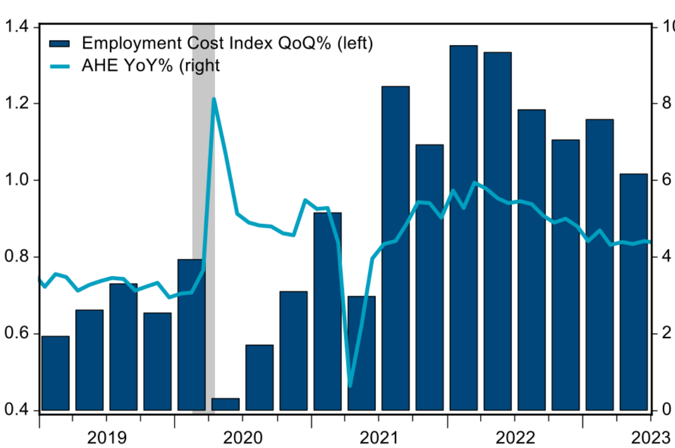
Despite over 500 basis points (bps) of tightening, the labor market remains solid, perpetuating optimism the Federal Reserve (Fed) may be able to achieve the elusive "soft landing." The bright spot of the U.S. economy, however, is beginning to show signs of cooling, a welcome step towards restoring balance.

While the Committee is not specifically targeting a rise in the unemployment rate, a negative impact on employment is presumed a necessary consequence to achieve price stability. Of course, the longer it takes to achieve the desired effects of a less tight labor market, the more robust the policy response will potentially be, increasing the odds of a more precipitous downturn in the broader economy – eventually.

ELEVATED COST OF LABOR

The labor market remains surprisingly resilient, justifying a stronger response from monetary policy officials in the coming months. But while demand for labor continues to outpace the existing supply of workers, the differential between the two appears to be lessening with the pace of topline job creation slowing, reducing the pace of wage inflation. That is "a good prescription," Fed Chairman Jerome Powell noted at last month's press conference, "for getting where we want to get."

While still hiring, more recently businesses have needed – or opted for – fewer workers, removing at least some of the elevated pressure on hiring costs. July nonfarm payrolls rose 187,000, falling short of expectations and following an 185,000 rise in June, the weakest pace of job creation since December 2020.



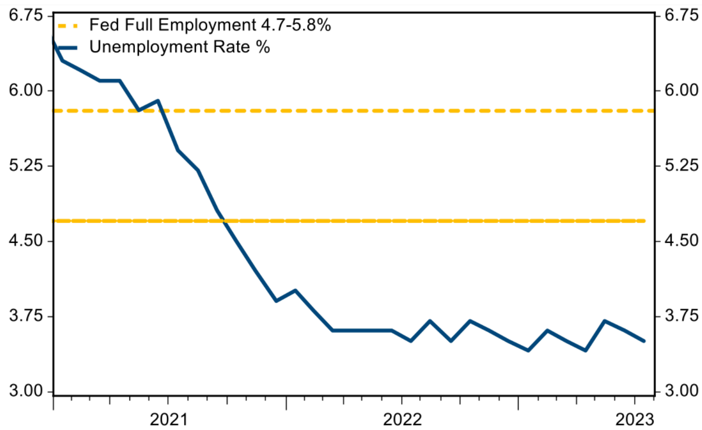
Source: Bureau of Labor Statistics/Haver Analytic

As a relatively "rare" input, labor costs have risen at an average pace of 5.0% since the start of 2022. While still accelerating, wage growth has slowed from a recent peak of 5.9% in March 2022 to 4.4% as of the latest July report. Additionally, employment costs, which are a broader measure of the price of labor including salaries as well as the cost of benefits, have slowed. They rose "just" 1.0% in the second quarter, following a 1.2% gain at the start of the year, marking the slowest pace of ascent since the first half of 2021.

Further upward momentum in labor costs is unlikely as the Fed continues to firm policy. Significant downward pressure, however, is equally unlikely until labor supply increases markedly or the demand for labor is sizably diminished as businesses find technological alternatives or falter under – eventually – slowing economic conditions.

A LACK OF ABLE AND WILLING BODIES

Despite rising uncertainty, if not outright expectations of a future downturn, for now, businesses are still expanding. Even at a slower pace of hiring, however, the pool of applicants continues to fall well short of market needs, underscoring the supply-side nature of the imbalance in the jobs market and the complicated equation for Fed policy.



Source: Bureau of Labor Statistics/Haver Analytic

The civilian unemployment rate remains near a five-decade low, falling to 3.5% in July, now dropping below the level of joblessness at liftoff in March of 2022. Driven down by a robust pace of job (re) creation in the aftermath of the pandemic, the historically low level of unemployment has also been artificially subdued due to sidelined workers. Whether due to lingering health concerns or a new outlook on the work-life balance, millions of potential workers are not actively participating in the labor force – and by extension, not included in the unemployment statistics.

At least some previously discouraged workers, however, are slowly filtering back into the labor market either by choice or by force as savings and stimulus fade. The labor force participation rate remains broadly 50 bps below the pre-pandemic average, holding steady at 62.6% in July. Although, in the last six months alone, nearly 1.3 million Americans have (re)entered the labor pool, a welcome influx for businesses still desperate for workers.

Employment vacancies are a natural component of the business cycle. At present, however, there are roughly 9.6 million vacancies. Down from a recent peak of 12 million in March 2022, the sizable reduction in job openings is another positive indication supply and demand are moving towards a better and sustainable balance. At the same time, the number of job vacancies is 2 million more than the pre-pandemic average and marks nearly two openings for every one individual that reports they are seeking a position of employment. In other words, while there are clear indications of cooling from peak distortions, the labor market still has quite a ways to go before returning to a sustainable equilibrium, keeping pressure on the Fed.

GLOSSARY

AHE – Average Hourly Earnings

YoY– Year over Year

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WEAKNESS IN HIRING WELCOME

While the Fed has been clear it is not aiming to specifically raise the unemployment rate, as policy makers continue to tighten policy, the (honest) realization is that the Committee is trying to slow the economy to tame inflation. As a result, at least some softening in labor market conditions should be expected – and welcome.

Up to this point, the Fed has been able to achieve at least some level of disinflation without a meaningful impact on employment, buoying confidence and expectations that a recession can be avoided altogether. However, the longer the imbalance between labor demand and labor supply remains, the larger the impact on labor costs or wage inflation, requiring a stronger response from monetary policy. Thus, the perpetual resilience of the labor market may be less an indication that broader economic weakness can be avoided and more of a warning sign that even higher rates are warranted and will – eventually – result in a more sizable downturn. In other words, drawing the same conclusion as former New York Fed President William Dudley, a downturn has likely been deferred, but not entirely deterred.

"Although the recent economic news has been reassuring, the economy isn't out of the woods. A hard landing might simply have been deferred, not avoided," Dudley noted in a Bloomberg Opinion piece published August 1.

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