Weekly Market Commentary

November 6, 2023

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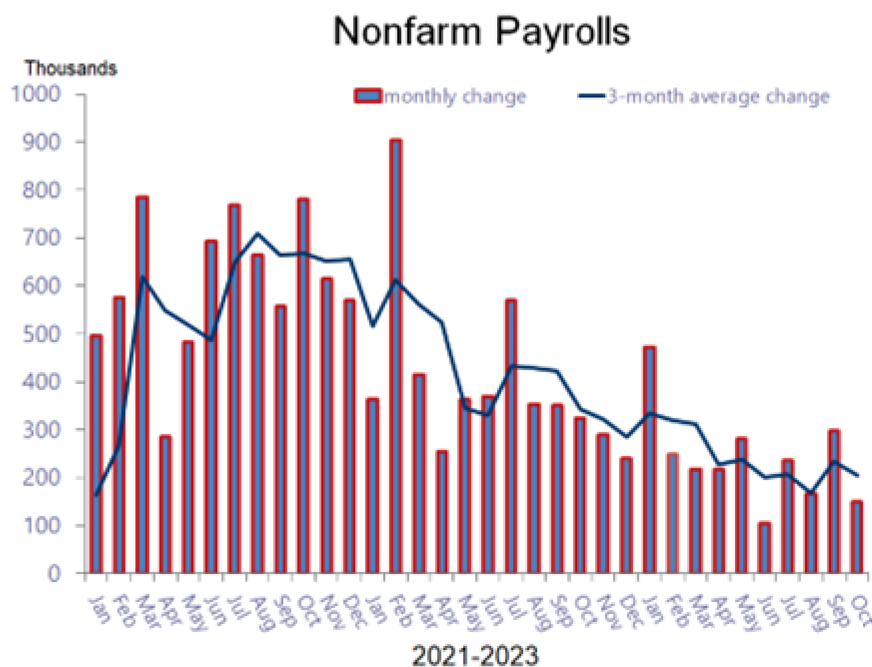
The forward momentum provided by the turbo-charged growth in the third quarter is rapidly dissipating. To be sure, the economy is hardly falling off a cliff, but if early data for the fourth quarter is any indication, its growth engine is downshifting markedly. The soft jobs report for October, released Friday, highlighted this trend and overshadowed the Federal Reserve's policy meeting this week. As expected, the Fed made no change in the federal funds rate, which now looks highly prescient in the face of this week's data. While it would be premature to expect the Fed to start cutting rates any time soon, the jobs report, as well as the latest surveys of manufacturing and services activity, weaken the odds of another rate increase. Investors are clearly echoing that sentiment, as the bond and stock bulls rampaged through the financial markets this week.

At his post-meeting press conference, Fed Chair Powell once again asserted that a softer labor market would be needed to get inflation down to the two percent target. No doubt, he was looking squarely in the rearview mirror at the blockbuster 336,000 increase in payrolls in September. Not only did job growth slow markedly in October to 150,000, but revised data for September and August sliced 101,000 from previous estimates for those months. Over the past three months, payroll gains have averaged 204,000 a month. However, downward revisions to initial estimates have occurred virtually every month this year, so the job market may be weakening more abruptly than incoming data suggests.



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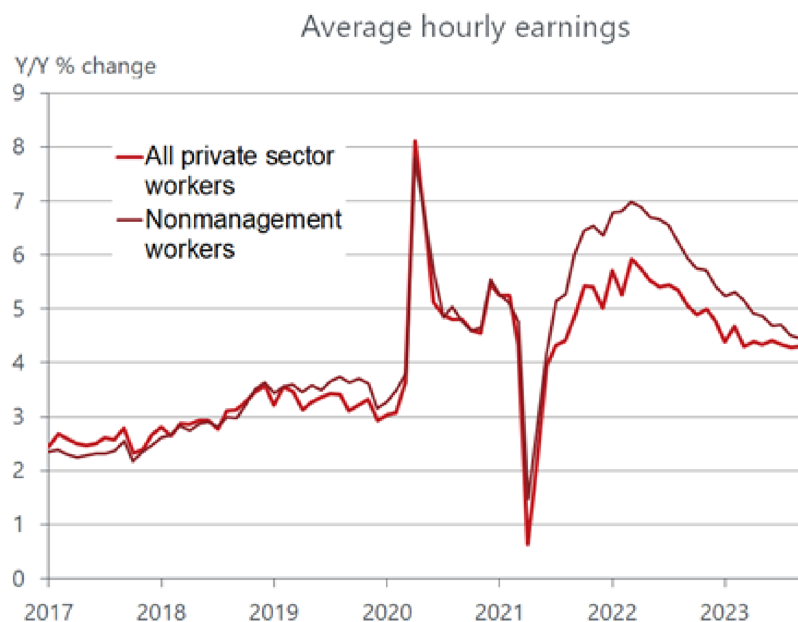
Clearly, the Fed has to be pleased with the latest jobs report, which is as close to a Goldilocks portrayal of events as possible. To be sure, the headline slowdown in jobs is somewhat tainted by the UAW strike, which removed 35,000 workers from payrolls. With the strike now settled, those workers will be returning to their jobs and inflate payroll totals in November. But the details of the jobs report are just as encouraging as the headline number, and they more than compensate for the likely bounce from the return of auto workers next month. While the strike certainly depressed manufacturing jobs in October, the slowdown in hiring was broadly based. Indeed, a paltry 52 percent of private industries expanded payrolls in October, the smallest share since the economy locked down in April 2020. In September, 61.4 percent of industries were increasing their workforce.

To be sure, anything above 50 percent means that more firms are hiring than firing, reflecting an economy that is still growing. From the Fed's point of view, that's a good thing because it ideally would like to squelch inflation without throwing the economy into a recession – achieving the so-called soft landing that has rarely been achieved during a rate-hiking campaign, particularly one that has unfolded as aggressively as the current one. But if a modest softening in job growth can temper wage increases and reduce pressure on companies to raise prices, that outcome becomes within reach. That's one reason the Fed has not raised interest rates at the last two meetings, as policymakers believe that past rate hikes have not yet had their full impact on economic activity. Rather than hike rates again, and risk pushing the economy into a recession, they are deciding to see whether the lags from past increases slow the economy just enough to tame inflation.

For that to happen, of course, labor costs would have to slow as well. In his comments to the press this week, Powell noted that most of the progress on inflation over the past year has reflected the healing of supply chain disruptions, which eliminated the shortage of goods that sent prices surging during the early stage of the post-pandemic recovery. With the supply of goods back to normal and demand for "things" satiated, consumers are shifting their purchases to services, where prices are heavily influenced by labor costs. The October jobs report provided more good news on this front. Average hourly earnings for all workers increased by a slim 0.2 percent during the month, lowering the increase over the past year to 4.1 percent from 4.3 percent in September. That's the slowest annual gain since June 2021.

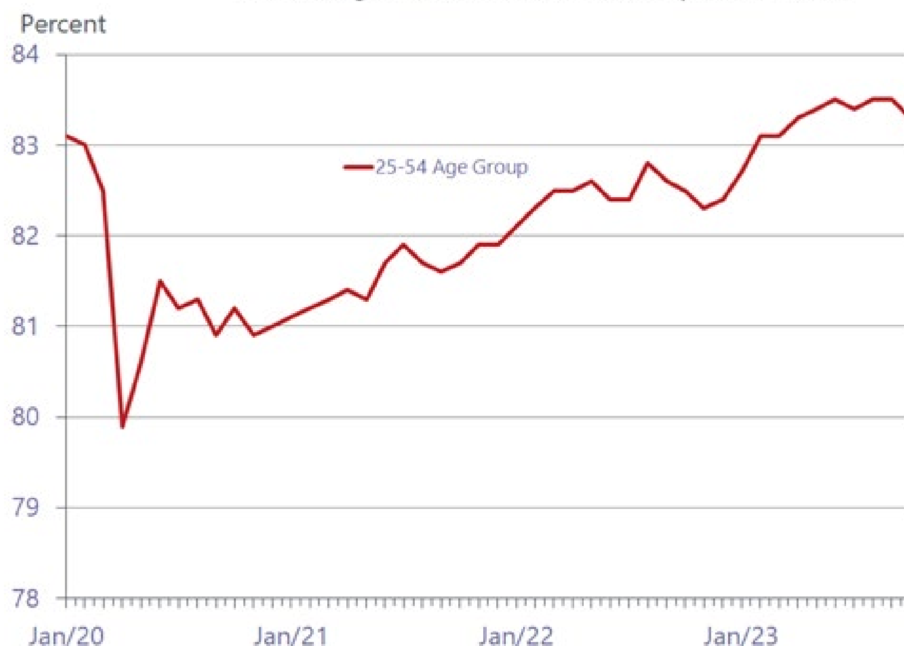


Admittedly, the average hourly earnings number provided by the monthly Labor Department's report is skewed by changes in the mix of jobs. If the growth in jobs is dominated by the hiring of low wage workers, that would lower the average for hourly pay, and vice versa if most hiring is for high-paying jobs. However, that was not the case last month, as most job gains in the private sector were in occupations that paid average wages. True, other wage measures – such as the Employment Cost Index released this week – adjust for changes in the job mix and showed a stronger increase in wages. But the most recent ECI data is for the third quarter, which, like the muscular GDP report for the period, is looking in the rearview mirror. We suspect that the October earnings report is more reflective of evolving conditions.

No doubt, the hefty pay increases obtained by the auto workers, as well as the previous settlement by UPS workers, suggest that worker bargaining power remains strong, pointing to continued upward pressure on labor costs. However, the large increases obtained by those workers followed years in which their pay lagged inflation, resulting in lost purchasing power. Hence, the generous labor contracts should be viewed as a recapture of real wages that fell behind in recent years. That's a far different situation from workers seeking pay increases to stay ahead of expected inflation, which would set in motion the dreaded wage-price spiral that underscored the inflation spike during the 1970s and prompted the Fed into a wrenching rate-hiking campaign that led to two severe recessions in the 1980s.

The current labor environment is far different than was the case then. For one, union power is greatly diminished, as only seven percent of workers in the private sector belong to unions compared to more than 20 percent in the early 1980s. For another, the exceptional tightness in the job market that strengthened the bargaining power of the UAW and UPS is unraveling. The unemployment rate edged up 0.1 percent to 3.9 percent in October and is now a half percent higher than in April. Indeed, it is even higher than the 3.8 percent that the Federal Reserve in September predicted would be reached by the end of the year. Meanwhile, the labor shortages that prompted employers to offer steep wage hikes to lure workers off the sidelines or from other companies have eased considerably.

The share of prime-age workers in the labor force shot above its pre-pandemic peak last April and remains above it, despite a downtick in October. With pandemic savings mostly depleted and job openings falling, people are more inclined to take a job now rather than later and risk staying unemployed longer than they want. Companies are not laying off workers, as labor shortages from a year ago are still fresh in their minds. But finding a job is getting harder as the number of laid-off workers receiving recurring unemployment benefits is steadily rising. Workers are not quitting their jobs as frequently as earlier this year and the number of new entrants to the labor force is climbing rapidly.



It's always dangerous to overstate the importance of a single jobs report. But from our lens, the breadth of the softness seen in the October employment data, together with the downward revisions to past months, suggests the Fed's tightening campaign is taking an increasing toll on the job market that is likely to persist in coming months. It also strongly indicates that the Fed is done hiking rates, a prospect that buoyed the stock market and sent market interest rates tumbling on Friday. We also believe that the last rate increase is now behind us and the Fed will soon turn its attention to the timing of its first rate cut. Chair Powell said that he and his colleagues are not even thinking about a rate reduction, but concentrating on getting inflation down to two percent, reaffirming the commitment to keep rates "higher for longer." Recall, however, that in late 2021, he also said that policymakers "were not even thinking about thinking of raising rates." Powell now admits that was a mistake and the Fed waited too long to start the rate hiking campaign. Time will tell if another mistake of waiting too long is in the making.