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CIO Viewpoint

US job market hints at progress in Fed's inflation fight

Investment Solutions

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The number of Americans looking for work remains close to fifty-year, pre-pandemic lows. Until now, record inflation and slowing growth had barely increased unemployment. Last week saw initial signs of a potentially looser labour market, one pre-condition for the Federal Reserve to slow the pace of its interest rate hikes, and avoid a severe recession.

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The US job market is moving, but slowly. Last week, the US reported an increase of 315,000 jobs in August compared with July, and an unemployment rate rising for the first time in six months to 3.7% from 3.5% a month earlier to a total of 6 million. As the Covid pandemic's impact on the economy faded and businesses re-opened, labour supply fell even as consumer demand for goods and services increased. That has left companies trying to keep existing staff, or hire the fewer available workers, on higher wages. The resulting inflation presents a challenge for the Fed to redress without triggering a severe recession. While the central bank cannot increase the number of workers, higher interest rates should eventually reduce demand for them.

Price stability, or bringing inflation under control, remains the number one goal for the Fed. But until workers feel that there are fewer jobs available, they may ask for higher pay, so 'anchoring' expectations of higher future prices. That makes inflation more persistent. While there is some lag in the effect of monetary policy on job markets, the longer that the job market looks unresponsive to higher interest rates, the tighter monetary policy must become, increasing the risk of tipping the US economy from a mild slowdown into a more severe contraction.

The labour market "is clearly out of balance," said Fed Chair Jerome Powell in a speech on 26 August. "History shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting." Mr Powell's speech, delivered at the Jackson Hole, Wyoming gathering of central bankers, was notable in underlining the Fed's determination to continue monetary tightening. That determination appears to lower the chances of the rate hiking cycle reversing in 2023. Inflation has started to show signs of easing and hourly wages declined in August. However, wage growth is on course to rise by an annualised 5%, which is clearly incompatible with the Fed's average inflation target of 2%.

Key takeaways

- US unemployment rose slightly in August to 3.7%, a first increase in six months and sign that Fed's monetary tightening is reaching the job market
- The workforce's 'participation rate' improved, increasing supply of labour, while wage growth has started to slow
- Labour markets nevertheless remain close to full employment and a key variable in the Fed's monetary policy outlook
- Our base case remains for a mild US recession in 2023. That prospect would offer some support to risk assets.

The next inflation report scheduled for release on 13 September will be an important indication for the Fed in its decision between a 50 or 75 bps rate hike. We see the US benchmark rate peaking at 3.75% early in 2023, enough to slow the economy into a mild recession.

For now, economic data is not consistent with a contraction in the first half of 2022, and many of the other conditions for an improving inflation outlook are already in place. With the hiking cycle well under way, the US economy is slowing as the cost of borrowing and mortgages rise, commodity prices and demand decelerate, and supply chains and shipping prices improve, allowing firms to rebuild inventories.

In the first half of 2022, solid corporate earnings supported demand for labour. Investors' focus is now moving to lower valuations as firms prepare for slowing demand and pressure on their margins. That may be contributing to less call for new hires.

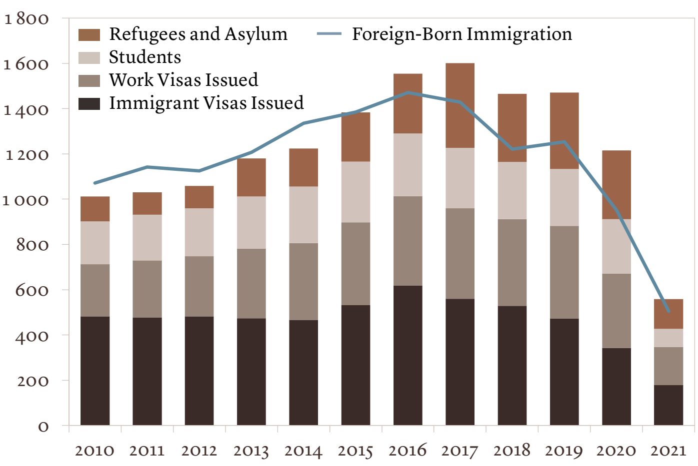
'Out of office'

Still high employment levels are at least in part a consequence of some 3 million workers leaving the labour market. The US still has fewer workers in the economy than before Covid, although in August more people joined the workforce. While the headline unemployment rate has recovered to its pre-pandemic lows, the 'participation rate' in August was 62.4%, slightly higher than July, but still a full percentage point below its pre-pandemic level. That difference may overstate the change over the past two-and-a-half years because an estimated two-thirds of these missing workers are thought to be the natural result of an ageing population, and people choosing early retirement. In addition, the pandemic saw immigration fall by two-thirds since a recent high in 2017 (see chart 1), and the still-poorly understood impact of 'long Covid' symptoms, which may affect as many as one-fifth of those who have been infected, according to the Centers for Disease Control and Prevention. However, this still leaves some 'prime age' workers – aged between 25 and 54 – missing from the labour force, compared with pre-pandemic, although that too is narrowing (see chart 2).

We see two scenarios. First, in our base case, the Fed's hiking cycle is succeeding in curbing inflation and inducing a mild recession in 2023, consistent with rates peaking at 3.75%. As markets get closer to fully pricing in this scenario, risk assets should find support. However, if inflation remains persistently high, the Fed may need to resort to even more restrictive monetary measures to cool economic activity. That could tip the US economy into a severe recession, weakening the outlook for risk assets further.

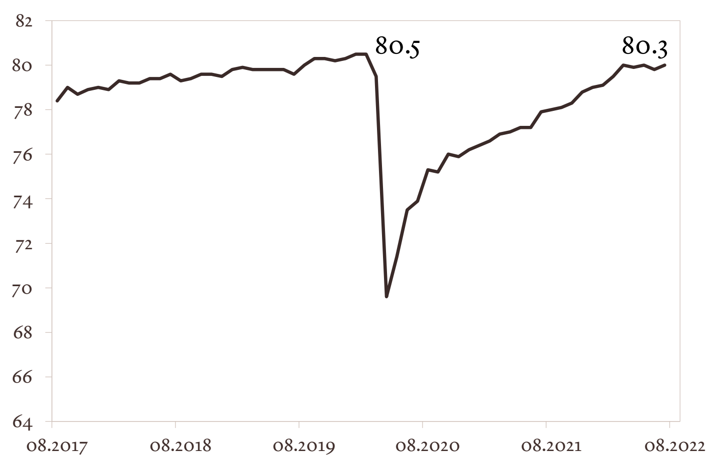
1. Lower levels of net immigration

In thousands - labour supply 1 mn lower (and unlikely to come back)



2. Prime age employment rate (25-54)

In % – about half a percentage point below pre-Covid high



Sources: Bloomberg, BLS, Lombard Odier calculations

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