There are signs that investors are realizing it will take more than just softer consumer price inflation data for the Fed to pivot. (UBS)

Tight US labor market points to further Fed rate hikes

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US equities are on track to end the first week of 2023 lower, undermined by concerns over further rises in US interest rates even as data show signs of a slowdown in various parts of the economy. The S&P 500 and Nasdaq 100 are down 0.8% and 1.8%, respectively, so far this week and heading for a fifth weekly decline, which would be their longest losing streak since May.

News of more layoffs (Amazon) and production cuts (Apple) at major tech firms, declining profits in the chip sector (Samsung Electronics), and price cuts in the EV sector (Tesla) are also weighing on growth stocks. Earlier this week, the US ISM manufacturing index fell to 48.4 in December, the lowest reading since May 2020.

But even though the economy is slowing, and despite high-profile tech job cuts, we believe that the Federal Reserve will need to see a weaker labor market and slower wage growth before calling a halt to its tightening cycle. Indications are that the labor market remains very tight:

- **Private payrolls remain strong.** ADP's report of private payrolls for December showed a strong gain of over 235,000, well above expectations for 150,000. November's data was also revised higher to 182,000 from 127,000.
- **Unemployment remains low.** Weekly initial claims for unemployment benefits fell to a three-month low of 204,000 in the last week of December, versus expectations for 225,000. While there may be an element of seasonal distortion in the data, it still points to a strong labor market.
- **Job openings far outweigh the number of unemployed.** This week's JOLTS data showed that job openings dropped by just 54,000 month-over-month in November to 10.46 million and there are 1.74 vacancies for every unemployed person. Importantly, the quit rate remains high, which is associated with strong wage growth. The Atlanta Fed's wage growth tracker shows that job switchers are achieving wage growth of 8%.

Focus is now on December non-farm payrolls due later today. Consensus estimates point to a rise of 200,000 versus 263,000 in November, while average hourly earnings are expected to have increased by 0.4% m/m and 5% y/y. That would

be the smallest gain in payrolls in two years but would not indicate a rapidly cooling labor market. Even if today's numbers surprise to the downside, we doubt it will be sufficient to spur the Fed to further scale down its rate hikes in the near term.

There are signs that investors are realizing it will take more than just softer consumer price inflation data for the Fed to pivot. Fed fund futures pricing for the peak in policy rates this year have moved back above 5% to 5.04% at the time of writing and has pushed further out to July. Against this backdrop, we think the macroeconomic conditions for a sustained equity rally are not yet in place and maintain an overall defensive stance. In equities, we prefer sectors like healthcare and consumers staples as well as more value-oriented markets like the UK compared with the more tech-heavy US market.

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