



CIO expects this year to bring inflection points in inflation, interest rates, and growth and as these come into view later in the year it will be appropriate to consider tilting toward a riskier stance overall. (UBS)

# Wanted: A more balanced labor market

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## **Investors saw plenty of reasons to cheer the December jobs report Friday.**

On the one hand, payroll growth of over 200,000 and an unemployment rate of 3.5%, a 50-year low, certainly does not suggest a recession is imminent. Even better, wage growth appears to have slowed in recent months. This should be good news for the Federal Reserve, which has been concerned that an unusually tight labor market will keep inflation elevated. But it is still too soon to expect the Fed to pause its hiking cycle as, by other measures, the labor market remains extremely tight.

## **Mind the gap**

The monthly labor report consists of two separate surveys, one conducted on establishments and the other on households. In recent months, the surveys have diverged widely, with the establishment survey pointing to solid demand for labor while the household survey has shown signs of slack. This divergence has cast some doubt on the veracity of the payrolls data, especially given the magnitude of hikes that the economy had to endure in 2022.

In the latest reading, the household survey played a little catch-up. The establishment survey for December showed nonfarm payrolls increasing by 223,000, above consensus expectations of 203,000 but still the slowest job growth since December 2020. The household survey was stronger, with the labor force participation rate ticking up to 62.3% and the unemployment rate falling to 3.5%, matching the pre-pandemic level at a 50-year low. The implied increase in employment in the household survey was 717,000, helping to make up for the weak growth in recent months. But the data remain murky. Even after the December report, there is still a large gap of over 1 million between the establishment and household surveys. Some of this difference may be explained by recent immigrants finding jobs, which is more likely to be captured by the payroll data than by the household survey. Next month, the Bureau of Labor Statistics will revise the payroll data for 2022 and this may help to narrow the gap between the two job measures.

Also out last week was the latest JOLTS (Job Openings and Labor Turnover Survey) data. It showed job openings falling only slightly to 10.5 million in November, versus the 5.7 million unemployed in the household survey. That gap between openings and unemployed workers is a measure of labor market tightness that Fed Chair Powell in particular has mentioned frequently in his recent public remarks. There was also an increase in the number of people quitting their jobs, an indication of labor market strength, since most people voluntarily leaving their jobs do so because they already have a better alternative. Combined with the drop in the unemployment rate, the strong data on openings and quits makes it appear that the labor market remains very tight.

### **Wage growth slowing, but not yet ideal**

Minutes from the December FOMC meeting released last week confirmed that the Fed wants to see a better balance between supply and demand for labor before considering a pause in the hiking cycle. A more balanced labor market would help to lower wage growth and reduce inflationary pressure.

Assuming productivity growth of 1.5% per annum, which is fairly generous relative to recent history, wage growth of 3.5% is about the maximum that would be compatible with the Fed's 2% inflation target. The establishment survey showed average hourly earnings up a moderate 0.3% month-over-month in December and there were downward revisions to previous months. The annualized pace of wage growth over the three months through December was only 4.1%, getting closer to the right range for the Fed.

### **Looking for more evidence**

But the Fed will not put too much stock in one indicator. The Employment Cost Index (ECI) for 4Q22 is generally considered to be more reliable than average hourly earnings, and it will be interesting to see if it verifies that wage growth is slowing.

Heading into the next FOMC meeting, which starts on 31 January, there will be a lot for the Fed to consider in addition to the labor market data.

Last week, the ISM Report on Business showed both the Manufacturing and Services PMI below the neutral level of 50 in December, suggesting that the Fed's previous rate hikes are gaining traction and slowing the economy. However, the Atlanta Fed's GDPNow tracking estimate of growth in 4Q22 was revised up to 3.8%, suggesting that the economy is accelerating.

This week, the NFIB survey of small businesses and CPI data for December will provide further information on labor market conditions and inflation. We expect the market to be hyper-focused on the CPI, but at this point the NFIB survey may be more important.

With so many contradictions in the recent economic data, the Fed is likely to put more emphasis on what its own business contacts across the country are saying. This information will be compiled into the Fed's Beige Book, due to be released on 18 January, and the NFIB survey may provide something of a preview.

### **What should investors do?**

The data continues to be mixed and therefore it is still too early to expect the Fed to pivot policy. We expect markets to remain volatile and do not think macroeconomic conditions support a sustained rally in equities. Against this backdrop, within equities, we continue to favor more defensive sectors like consumer staples and healthcare and maintain our preference for value over growth. In fixed income we prefer high-quality bonds, while remaining more cautious on riskier credits.

That said, we do expect this year to bring inflection points in inflation, interest rates, and growth and as these come into view later in the year it will be appropriate to consider tilting toward a riskier stance overall.

Read the original report [Wanted: A more balanced labor market](#) 9 January 2023.

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