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Weekly Market Commentary

January 9, 2023

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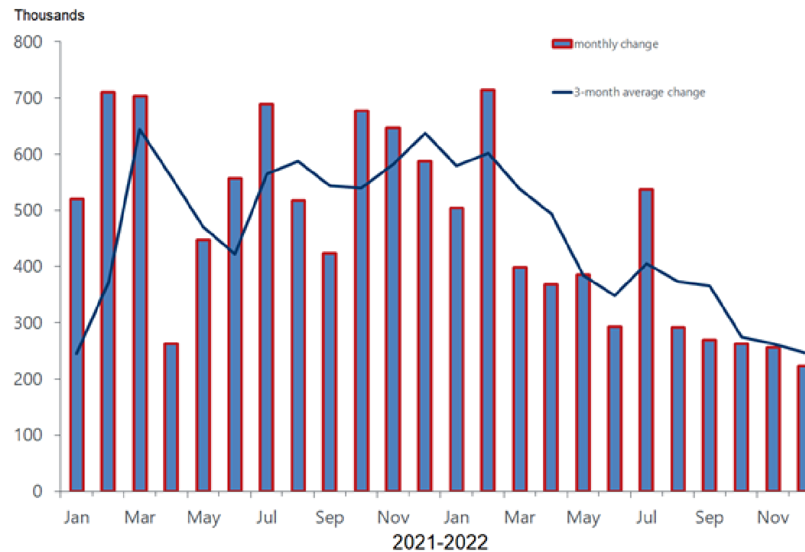
The jobs report on Friday understandably took center stage this week. Aside from it being a key barometer of the economy's underlying strength, when viewed alongside previously released data, it also highlights a growing debate that is gripping the financial community. At issue is whether the Fed needs to keep its foot on the monetary brakes until labor conditions weaken enough to slow wages – and hence inflation – or is inflation already firmly on the slowing path as the economy continues to normalize? For example, the anticipated post-lockdown shift in consumer spending from goods purchases towards services is having the predictable effect of easing price pressures on goods. That was brought into stark relief again in the ISM manufacturing report earlier this week that saw prices paid by goods producers plunge to the lowest level since April 2020 in December.

Meanwhile, the normalizing of spending is also having a palpable impact on employment trends, as sectors that enjoyed strong demand from homebound consumers during the height of the pandemic are now overstaffed and laying off workers. This week's announcement that Amazon is shedding 18,000 workers augments a growing list of companies in the tech sector doing the same, as households are devoting more of their dollars to experiences, including visiting stores and restaurants instead of relying on the internet and computers to satisfy their shopping needs. Wage trends echo this change in spending behavior, as lower-paid workers, who tend to be more prevalent in services, are enjoying faster wage increases than those in higher paying sectors.

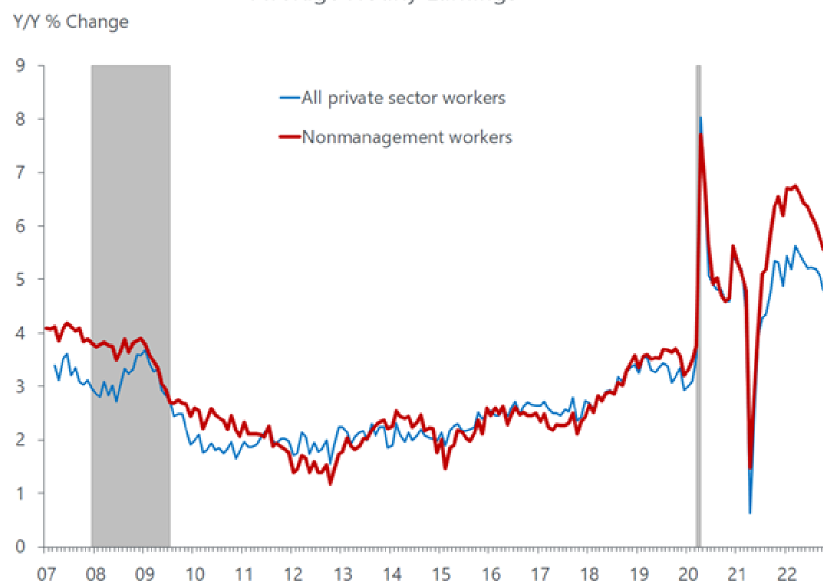
Importantly, the recalibration of economic activity as the economy normalizes is occurring amid a vibrant job market that the Fed continues to see as its main obstacle to rein in inflation. Job growth did slow, as expected, in December, but the 223,000 increase in non-farm payrolls is still well above the pre-pandemic pace and punctuates a year in which a whopping 4.5 million jobs were created. Not surprisingly, the service sector is spearheading the increase in jobs, led by education and health services followed closely by leisure and hospitality companies. The latter added 67,000 workers last month, contributing 30 percent to the total gain in payrolls. That's an outsized contribution from a sector that accounts for only 10 percent of total employment. Still, there are almost one million fewer workers in leisure and hospitality than before the onset of the pandemic, and employers are paying a premium to get them back. Average hourly earnings for these workers increased 0.7 percent in December, more than double the 0.3 percent increase for all private-sector workers.

Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

Scott Wood
Portfolio Strategist
Email: swood@vfccu.org
Phone: 800-622-7494 ext. 1631



Clearly, there continues to be a wide imbalance between the demand for workers and supply of labor in some sectors, particularly the lower paying ones, that is putting upward pressure on wages and prompting employers to either raise prices or sacrifice earnings. But even in these sectors, wage growth is slowing. In the spring, average hourly earnings in leisure and hospitality were increasing by more than 10 percent from a year earlier; in December, the annual increase slowed to 6.4 percent. Likewise for the broader workforce, as earnings growth slowed to 4.6 percent last month from a nearby peak of 5.6 percent in March. And while wage growth is still stronger among lower paid workers the slowdown here has been just as dramatic. For all non-management workers, the annual increase in average hourly earnings fell to 5.0 percent in December from 6.8 percent in March.



The significant point to note is that the slowing wage growth is occurring in a job market that on the surface is becoming ever tighter. In December, the unemployment rate fell to a near historic low of 3.5 percent from a downward revised 3.6 percent in November and, going into the month, job openings at 10.5 million remained 1.7 times greater than job seekers. This confluence of events flies in the face of the celebrated Phillips Curve that posits wage growth should accelerate as the unemployment rate declines. But in an environment that is unwinding from historic pandemic-induced imbalances, that linkage may have less relevance. While the economy has recovered all its recession job losses and then some – total employment stands 1.25 million above its pre-pandemic peak – the labor force has been slow to recover and is only about 250,000 above its peak reached in December 2019. If the labor force participation rate had returned to the 63.3 percent in effect prior to the pandemic, the economy would have close to three million more workers available than it currently has. That, in turn, would go a long way towards easing the labor shortage that is currently keeping the Fed's foot on the inflation-fighting brake.

The good news is that the labor force staged a healthy 439,000 increase last month and workers entering the job market had little trouble landing a position, resulting in the dip in the unemployment rate. What's more, despite the expanding labor supply, workers who were unemployed in November rapidly found new positions in December, lifting the job-finding rate back to near historic highs. This ease with which laid-off workers can land a new job may be one reason the headline-grabbing layoffs in the tech sector are not translating into rising unemployment claims. It also underscores the elevated pace of job quitters, as workers are confident they have a landing place waiting for them within a short time.

Simply put, the December jobs report does little to resolve the debate regarding how much more pressure the Fed needs to apply to wring excess inflation out of the economy. The doves can correctly point to the slowing growth in wages and consumer prices that is clearly underway, despite the still-healthy pace of job creation.

They argue that while labor shortages persist, particularly in specific service sectors, wage pressures should continue to ease as more supply comes on stream and workers become more concerned over job security amid growing recession fears, stoked by attention-getting media reports and the increasingly gloomy outlook of corporate CEOs. It may take longer for organic forces to bring inflation back to its pre-pandemic pace, but the wait is worth avoiding the severe economic damage that an overly aggressive Fed-induced recession would bring about.

For its part, the Fed rejects the notion that an “immaculate disinflation” would unfold as long as a buoyant job market can drive up wages and keep pressure on employers to jack up prices. It argues, understandably, that two months of cooling CPI data is not enough evidence that inflation has been stopped in its tracks and the rise in labor costs, though slowing, is still inconsistent with its two percent inflation target. Getting there will require more than patience; only additional nudges in the form of higher rates to cool off the economy would do the job. No doubt, the December jobs report provided more cheer for the financial markets than it did the Fed, as stocks rallied sharply on Friday and bond yields fell. But investors were buoyed more by the slowing wage data than the still robust increase in payrolls. We believe the Fed had just the opposite reaction and the strong increase in jobs will tilt it towards another rate hike at its next meeting in February and raises the odds of an additional increase in March.

And while the markets rallied on Friday, investor perceptions can change on the dime. That said, one thing is clear: The proverbial Fed put is officially dead this year. The Fed put is the belief by investors that the central bank will step in and support markets if equity prices decline too much. However, the minutes from the December policy meeting released this week dashed these hopes. In it, policymakers expressed concern that, because monetary policy works importantly through financial markets, an unwarranted easing in financial conditions, especially if driven by a misperception by the public as to the Fed’s intentions, would complicate the Committee's effort to tame inflation. In other words, should stocks continue to rally and bond yields fall, the Fed would be more likely to clamp on the monetary brakes even harder.