Weekly Market Commentary

March 11, 2019

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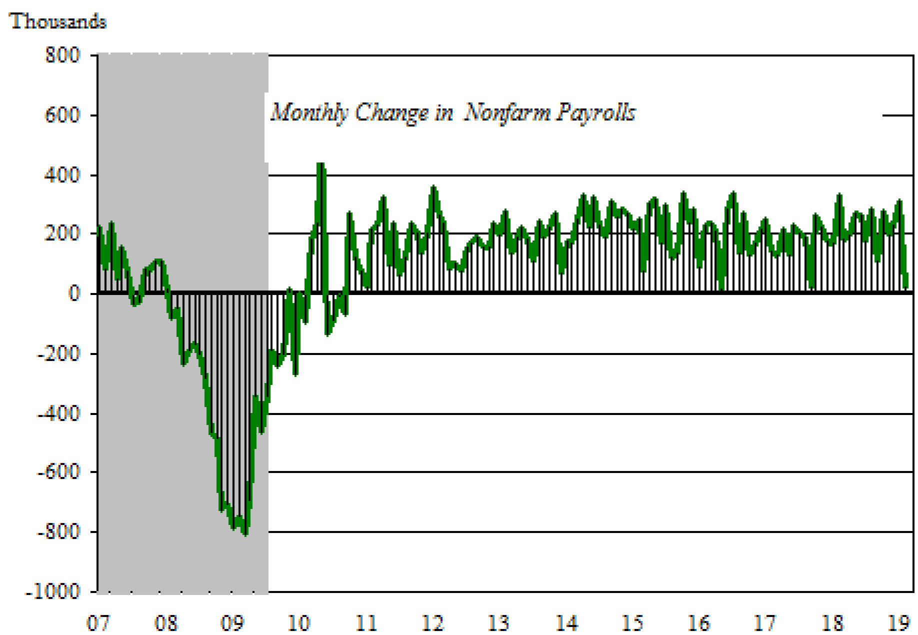
The headline report of a shockingly weak 20 thousand gain in employment last month took the markets by surprise, as Wall Street had expected a much stronger increase of about 180 thousand. However, when a monthly number is so far off the consensus forecast, it is understandably viewed with suspicion – and this time is no different. While a slowdown in job growth has long been expected the drop-off from the 311 thousand increase in January, revised up from 304 thousand, was far steeper than indicated by the economy's underlying fundamentals. What's more, the headline slowdown in nonfarm payrolls masks some positive developments in the details of the employment report.

Job Growth Slows



Yes, economic growth is slowing. But just as the eye-opening 311 thousand surge in nonfarm payrolls in January – which far exceeded expectations – exaggerated the economy's strength, the drop-off in February overstates the evolving weakness in activity. Adjusting month-to month volatility in economic data caused by seasonal forces is always a challenge for government statisticians, but the task is even more difficult during the winter months when weather-related influences play a more important role. In addition to some heavy snowstorms last month, the government shutdown and its aftermath distorted the results as well.

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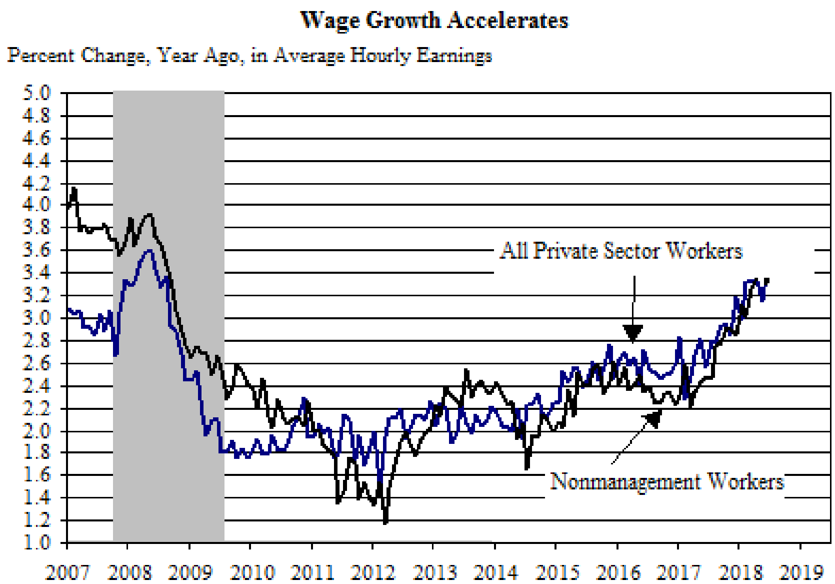
For this reason, economists like to smooth out the monthly variations to get a better sense of underlying trends. From this perspective, the job market is still in a healthy state, as nonfarm payrolls increased by an average of 186 thousand over the past three months. That's virtually spot-on with what was expected for February and well above the perceived trend growth rate in the labor force, which is closer to 100 thousand a month. Just as the strong January report did not prod the Fed to reverse its shift to a more dovish policy stance, Friday's weak headline report should not nudge it in the other direction, raising the odds of an imminent rate cut. Indeed, most details in the latest jobs report should stiffen the Fed's resolve to sit on the sidelines until a clearer picture of the economy's direction comes into view.

As noted, the impact of weather could be plainly seen in the latest jobs' reports. The two most weather-sensitive industries – construction and leisure and hospitality – showed the largest month-to-month swings in payrolls. Construction jobs plunged by 31 thousand in February following a 53 thousand increase in January. It is unlikely that a boom-bust pattern of building activity occurred over the two months. Likewise, payrolls were unchanged in the leisure and hospitality sector in February following a whopping 83 thousand increase in January. Neither is reflective of the underlying trend in this sector, but the 41 thousand average increase for the two months is more in line with the 34 thousand average monthly gain over the past year. This sector includes a lot of part-time jobs whose ranks may have been temporarily swollen in January with furloughed government workers. Not coincidentally, part-time jobs plunged in February, contributing to the sharpest fall in the broader unemployment rate on record.

If hiring were falling off a cliff as suggested by the headline slowdown in payrolls, it would significantly erode the bargaining power of workers. But that clearly was not the case last month. Average hourly earnings of all private-sector workers jumped by 0.4 percent in February, lifting the annual increase to 3.4 percent, the highest since the recession. Encouragingly, the buoyant job market is fattening the paychecks of midlevel workers – those in production and non-management positions – as much as those higher up the income scale. Their average earnings also increased by 0. 4 percent for the third consecutive month, lifting the annual gain to an even stronger 3.5 percent. Importantly, the benefits of a strong job market are trickling down to the less skilled segment of the population. While the overall employment/ population ratio held steady at 60.7 percent last month, the share of workers with less than a high school diploma actually increased by nearly 2 percentage points. At 44.6 percent, the employment/population ratio for this group was exceeded only once before since records began in 1992.

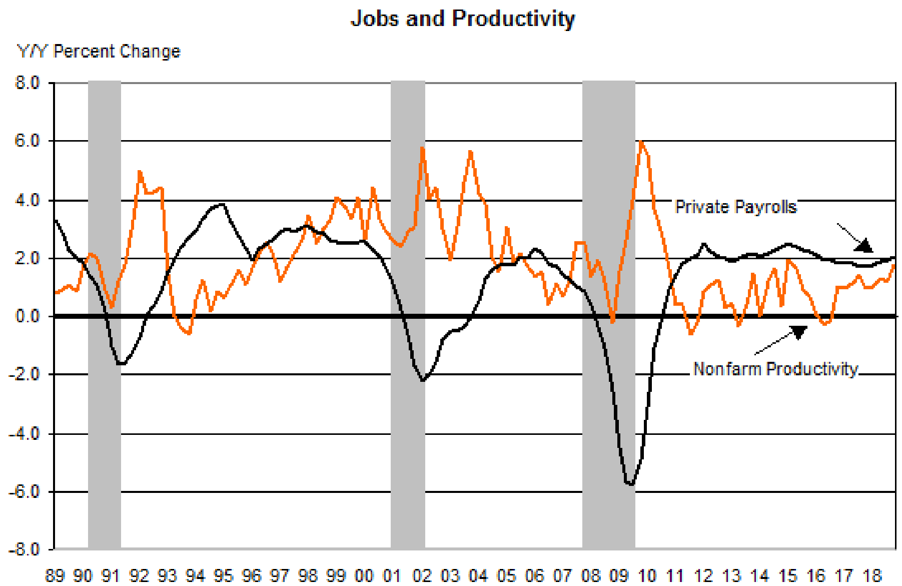


But as with the weak headline reading on job growth, the Fed is not likely to respond to accelerating wage growth, fearing that it will spur higher inflation. Unlike the bargaining power of workers, business-pricing power does not seem to be increasing. Inflation has still not broken through the Fed's 2 percent target and the central bank has expressed a willingness to tolerate a drift above that threshold for a while, particularly if it occurs in a slowing growth environment. Not only is the U.S. economy on a slower growth trajectory, the global economy is experiencing a more profound downshifting of activity. That's especially the case in Europe, where Germany, the region's main growth driver, barely escaped a recession last year. The European Central Bank, in turn, announced on Thursday that it was postponing a planned rate hike for September until at least 2020 and will be providing banks with zero-interest loans to stimulate lending.

To be sure, the tame inflation backdrop in the U.S amplifies the purchasing power gains associated with the muscular pay increases workers are now enjoying. Real average hourly earnings increased by about 2.0 percent in January from a year earlier, a respectable gain that is likely to increase further following next week's CPI report for February. The question is, how much improvement on the wage front can occur without causing serious erosion in business profits or a spike in inflation? A key answer lies with productivity; the more output workers can generate per hour, the more revenues companies have for pay raises without damaging profits or having to increase prices. Strong productivity growth is a time-honored vehicle for higher living standards in the U.S.

Interestingly, stronger productivity growth is also often accused of being a job killer. That notion has taken on ever-more significance in recent years, as labor is increasingly concerned that the rapid growth in robotics and artificial intelligence in general will perform a widening swath of tasks that will replace workers in the process. As it is, companies tend to step up productivity-enhancing capital spending late in a business cycle to compensate for labor shortages and to circumvent paying the higher wages needed to attract workers. This dynamic leads to stronger productivity growth even as job growth slows.

However, this cycle seems to be following a different pattern. Unlike the previous three late-stage upturns, productivity and employment growth increased simultaneously through the end of last year. Nonfarm productivity growth hit a three-year high of 1.8 percent in the fourth quarter of last year, while private payrolls increased 2.0 percent compared to a year earlier, up from 1.7 percent in mid-2017. It remains to be seen how long this virtuous cycle can continue, but the productivity improvement so far has not shown its "dark side" of stifling job growth. If anything, it may help explain the noninflationary acceleration in wage growth that is currently unfolding.



Even with the setback in February, the annual growth rate in private payrolls averaged 2.1 percent over the first two months of the year, extending the gentle upward trend since the middle of 2017. The sustained above-trend growth in job creation has surprised most economists and confirms for many that the labor market has more slack than is indicated by the historically low 3.8 percent unemployment rate. Two trends seem to underscore that notion. For one, aging baby boomers are staying in the labor force longer than expected. The labor force participation rate for workers age 55 and older currently stands at a record 44.0 percent, up from under 30 percent in the mid-1990s. For another, more workers are being drawn off the sidelines than thought. The overall labor force participation rate held steady at a cycle high of 63.2 percent in February, up from a 38-year low of 62.5 percent in October 2015. Most thought that a wave of retiring baby boomers together with tougher immigration policies would have produced a much lower participation rate by now.

That said, the pool of available workers is clearly shrinking, and supply constraints will be one factor leading to slower payroll growth this year. The other will come from the demand side, reflecting a slowing economy that is facing stiffer headwinds from weakening global growth, trade uncertainty and tightening financial conditions, even as the tailwinds from fiscal stimulus steadily wanes over the course of the year. But barring some external shock that batters the financial markets or shatters business and household confidence, the growth slowdown should not morph into a recession anytime soon. The downside risks are growing and will become more acute as growth slows to under 2 percent by the end of the year, setting the stage for heighten recession fears in 2020.