Weekly Market Commentary

March 13, 2023

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The mixed messages coming out of Friday's employment report adds a layer of complexity to the Fed's rate-setting decision at its March 21-22 policy meeting. If nothing else, it imparts more importance to next week's inflation report, which could move the needle either way. If the CPI and its tangle of subcomponents come in hotter than expected, the odds of a 50-basis point rate hike loom larger; conversely, should this critical inflation gauge show more signs of cooling, Fed officials are likely to take a more cautious approach, keeping the rate hike at the smaller 25-basis point mark taken at the last meeting on February 1. Following Fed Chair Powell's hawkish congressional testimony this week, the markets priced in a greater probability of a 50-basis point increase, but Powell added a caveat in the second day of his testimony, noting that "no decision" had yet been made. We still expect the Fed to move by 25 basis points, but a hotter CPI next week would add an upside risk to that forecast.

That said, the Fed may have more than inflation on its mind at the upcoming confab, most notably the prospect that its actions could heighten the threat of a financial crisis. Importantly, the closure of a major bank this week indicates that the Fed-induced steep and rapid increase in interest rates is straining some sectors of the banking system. By and large, the system remains in good shape, with most banks retaining more than enough capital to weather adversity. But the balance sheets of lenders are vulnerable when adverse developments, including rising interest rates, impair the financial health of their customers, something that was clearly the case and spurred a run on deposits by the tech-heavy startups that caused this week's bank failure. The threat of a systemic disruption in the banking system is small, but the risk of stoking financial instability may well encourage the Fed to opt for a smaller rate increase at the upcoming meeting. The astonishing 45 basis point plunge in the Treasury 2-year yield on Thursday and Friday supports that prospect.

Nonetheless, the Fed was hoping the February jobs report would provide more clarity as to which would be a more appropriate move. A decisive downshift in job creation from the eye-opening surge in January would have provided a positive signal to go slower, particularly if the whopping 517,000 payroll gain in January were revised substantially lower. That would confirm the perception held by many that the original estimate was essentially a fluke, distorted by flawed data from a low response rate and unusually warm weather. A slowdown in wage growth would also tilt sentiment at the Fed towards a more dovish approach. The key takeaway the Fed is looking for is whether its aggressive rate-hiking campaign over the past year is loosening up the tight labor market and contributing to slower wage gains that would ease pressure on employers to raise prices. The jobs report, however, muddied the water, as it bolstered both the dovish and the hawkish points of view.

While the growth in payrolls did slow in February, the 311,000 increase was well above expectations of a 200-250,000 gain. Nor was the 13,000 downward revision to the January increase much to write home about. Simply put, the recent trend continues to run well above population growth of roundly 100,000 a month, meaning that employers will have to get workers off the sidelines to fill open positions.

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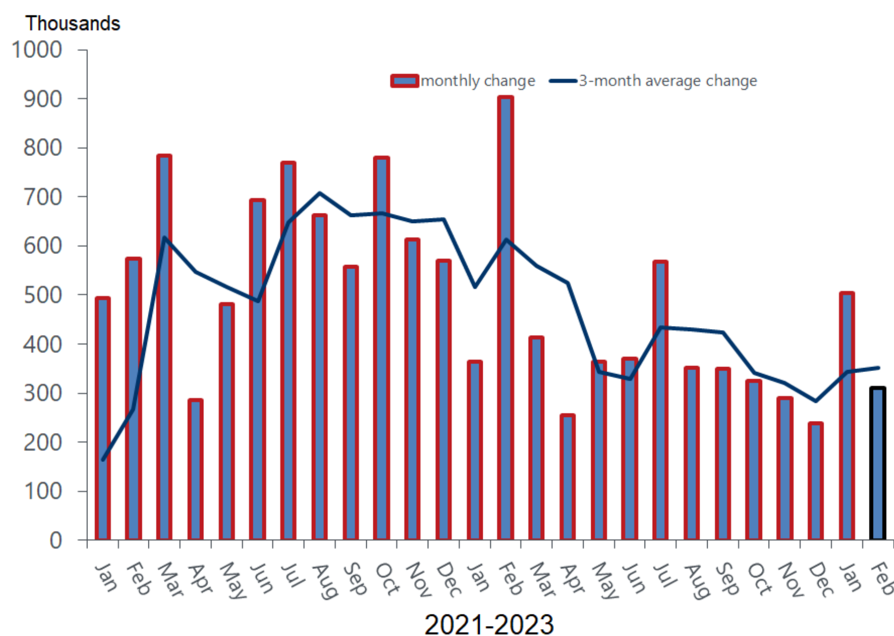
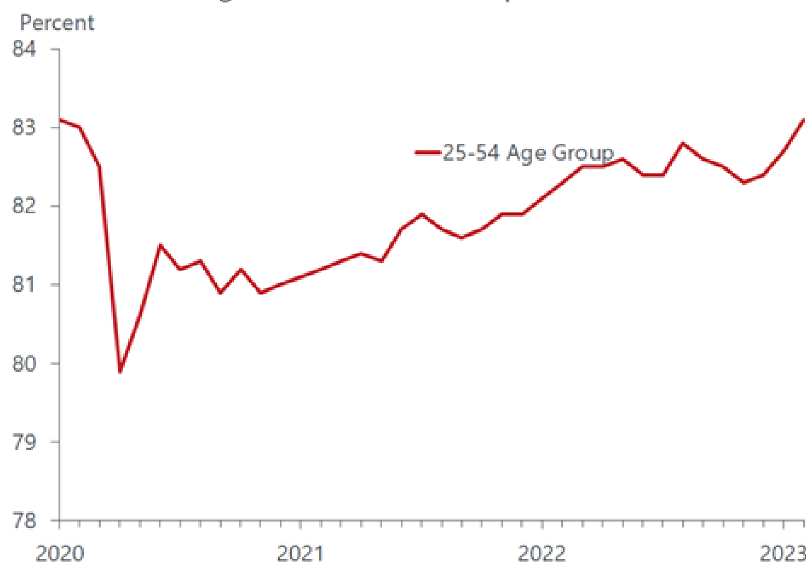
Indeed, the trend in job growth, even with the modest downward revisions for December and January, is moving in the wrong direction, as the average increase over the past three months has accelerated to 351,000 from a 284,000 monthly average in the three months through December. The ongoing vigor in payroll growth clearly goes into the hawkish side of the ledger at the upcoming Fed meeting.



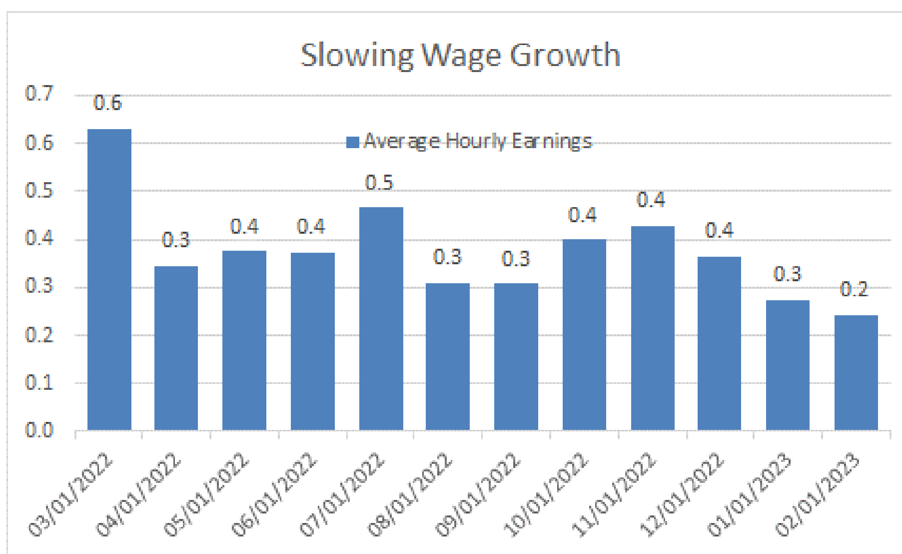
But the Fed is looking at the "totality of data" as noted by Powell, and the details in the jobs report takes some of the sting out of the strong payroll gain. Although the demand for labor is still too strong for the Fed's comfort, its impact on wages is diluted if the supply of labor shows a commensurate increase. That condition was more than met in February as the labor force expanded by 417,000, exceeding the number of people landing jobs. Hence, the unemployment rate rose from 3.4 percent to 3.6 percent, which is still historically low but bouncing off the lowest level in more than 50 years. It was also the first time in a year that the labor force expanded for three consecutive months, broadening the headcount by 1.72 million over the period.

Importantly, the supply of labor has been expanding faster than the working-age population, indicating that efforts to lure workers off the sidelines are bearing fruit. The labor force participation rate has increased for three consecutive months, climbing to 62.5 percent from 62.2 percent in November. That's still below the pre-pandemic level of 63.3 percent thanks, mainly, to an ageing population that is generating a wave of retirements and restraining growth in the labor force. But the critical prime-age group, workers aged 25-54, is taking up some of the slack. For the first time since the onset of the pandemic, the share of prime age workers in the labor force has returned to its pre-pandemic peak of 83.1 percent.



It's unclear what is bringing workers back to the labor force, but a variety of forces are in play. An improving health environment, which reduces fears of Covid infections, would seem to top the list, although office occupancy rates are still well below pre-pandemic levels. Pocketbook issues are also becoming more of a factor, as inflation together with dwindling pandemic-era savings are eating into household budgets, particularly among lower-wage earners. The attention-getting layoffs in the tech and financial services sectors may also be inducing people off the sidelines. Until recently, unemployed workers, flush with pandemic savings and reports of plentiful job opportunities, may have felt they can avoid the job search until the last minute, when landing a position would be easy. With high-profile layoffs grabbing headlines, recession fears growing and savings drawn down, that laid-back attitude may be falling by the wayside.

While fatter pay packages would seem to be another big inducement to get workers off the sidelines, that does not appear to be a major lure this time. One of the more dovish details of the latest jobs report is that average hourly earnings grew by a smaller-than-expected 0.2 percent in February, the slimmest increase in thirteen months and half the average 0.4 percent monthly increase over the preceding year. However, we doubt that the Fed puts too much emphasis on this encouraging detail, as the average hourly earnings series is heavily influenced by changes in the composition of the work force. If lower paid workers account for an increasing share of payroll gains, the average increase in wages would be skewed lower. Just the opposite happens when these workers account for the biggest share of job losses, as was the case during the height of the pandemic, which gave a big boost to average wages.



In February, the major job gainers were in lower paying industries, as leisure and hospitality, retail and government accounted for 201,000 of the 311,000 increase in nonfarm payrolls. That's a two-third contribution from a group that accounts for only 35 percent of total payrolls. Meanwhile, the industry with a high concentration of well-paying workers, information technology, shed 25,000 jobs during the month.

That said, the slowdown in average hourly earnings is consistent with other measures, such as the Employment Cost Index, suggesting an easing of wage pressures. What's more, while more jobs were created in February than expected, total hours worked declined and the weekly paychecks of non-management workers fell for the first time in two years. On balance, beyond the headline growth in payrolls, there are enough soft spots in the jobs report to limit the Fed's rate increase to 25 basis points at the upcoming meeting. A hot CPI report next week imparts an upside risk to that prospect, but heightened financial instability stoked by this week's bank failure could just as readily encourage the Fed to keep its finger off the rate trigger.