Weekly Market Commentary
November 7, 2022

Weekly Commentary

It's rare that the Federal Reserve holds its policy-setting meeting the same week that the jobs report is released. Each is a headline-grabbing event on its own; when they appear so close together, as was the case this week, the stage is set for fireworks. Unsurprisingly, the financial markets lit up this week, featuring sharp moves in both stock prices and yields. By week's end, the former was down and the latter up, reflecting evolving perceptions regarding monetary policy and the overall health of the economy.

The FOMC meeting that concluded on Wednesday ignited the frenzy, producing a message that was both comforting and disturbing to investors. As expected, the Fed hiked its short-term rate by another outsized 0.75 percentage point, lifting the federal funds rate to a range of 3.75-4.00 percent. Along with the announcement of the rate hike, the summary statement issued after the meeting conveyed the comforting thought that the Fed was poised to dial back future rate increases, beginning with the next likely hike in December. The prospect that policymakers would be easing up on the brakes sent stock prices surging for a brief time. But the relief rally was quicky extinguished following the post-meeting press conference. Simply put, Fed Chair Powell signaled that while the pace of rate increases may slow, the endgame will take longer to arrive and leave rates higher than expected a month ago. That hawkish message sent doves back to the sidelines with stocks falling and yields climbing.

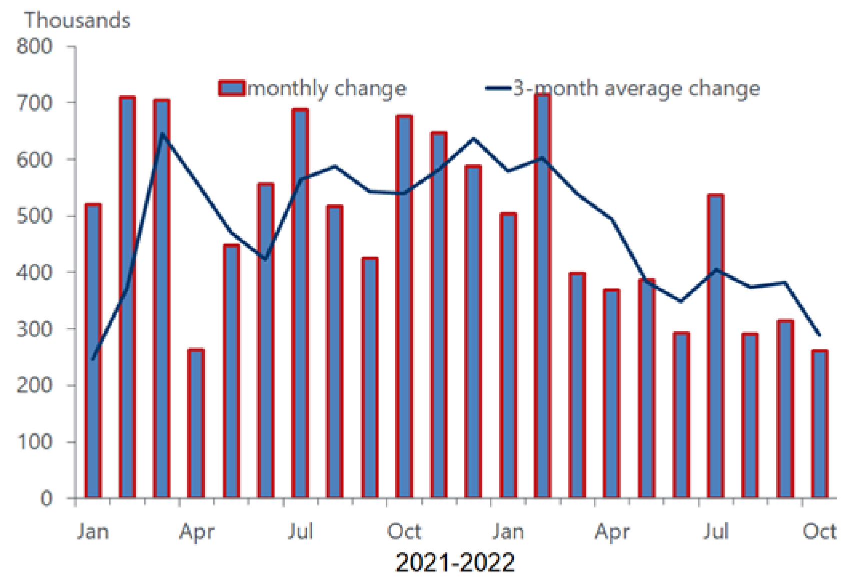
Following the FOMC meeting, all eyes turned to Friday's jobs report, looking for clues that would either confirm or weaken the Fed's message. Typically, the report did both, leaving more questions than answers by the end of the week. Supporting the hawkish stance, job growth came in stronger than expected in October, as non-farm payrolls increased by a sturdy 261,000, considerably more than the consensus forecast of just under 200,000. What's more, the payroll increase for September was revised up by 52,000, albeit the August gain was shaved by 23,000. After revisions, the 289,000 average increase over the last three months remains far too strong for the Fed's comfort, pointing to more rate increases in coming months.

Still, the jobs report did provide some encouragement for doves, as the monthly increases are downshifting; the 261,000 increase in October was the smallest since December 2020 and the three-month average gains are slowing markedly – to 289,000 in October from 381,000 in September. And while job gains are slowing, so too are the number of industries adding workers. In October, the proportion of industries expanding payrolls slipped to 61.7 percent from 64.3 percent in September; a year ago, that share stood at 73.0 percent. Additionally, the unemployment rate jumped to 3.7 percent from 3.5 percent, another sign that conditions in the labor market may be loosening up.

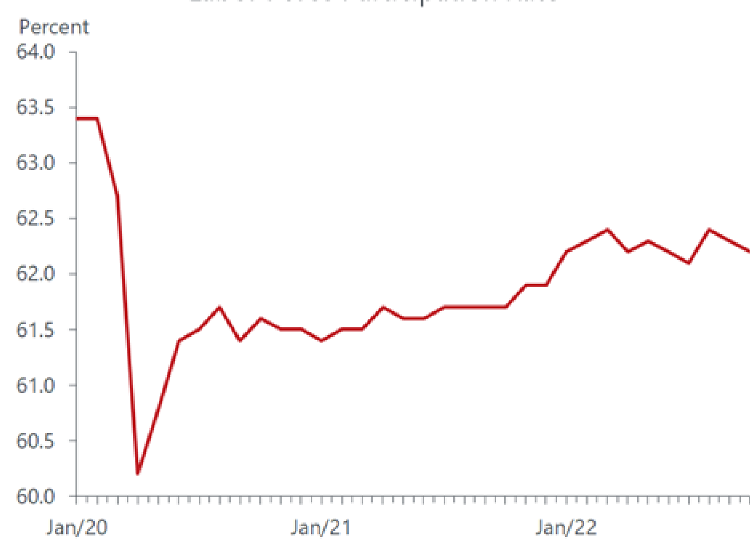
Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

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

Market Commentary provided by Oxford Economics. Content not written by Vizo Financial.

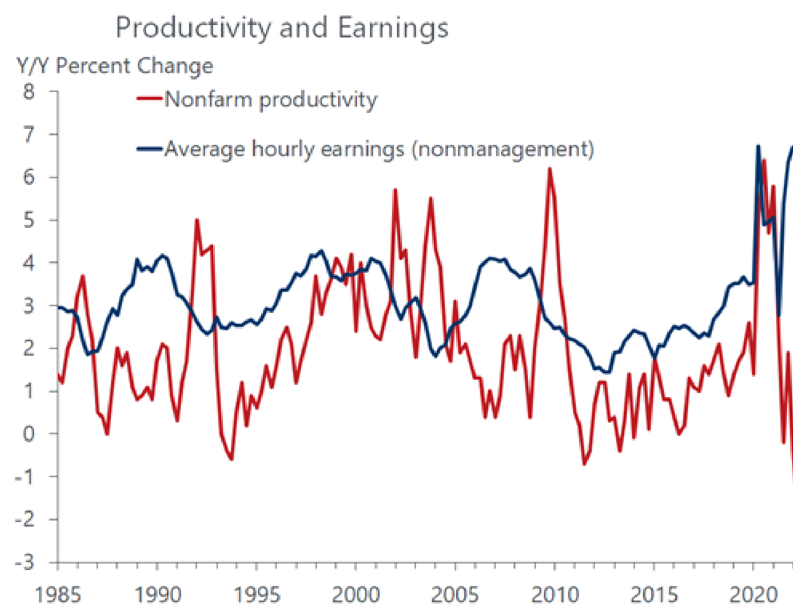


While there are conflicting messages in the jobs report, from our lens, the Fed's aggressive rate-hiking campaign has not yet cooled off a red-hot labor market enough. Until it comes off the boil, the task of bringing inflation under control will remain challenging. With almost two job openings for every unemployed worker, companies are forced to offer bigger pay packages to meet staffing requirements. Even so, the higher wages are not bringing workers off the sidelines. The labor force participation rate fell for the second consecutive month in October and, at 62.2 percent, is no higher now than it was in January. More tellingly is that the participation rate among prime-age workers, the 25-54 age cohort, also slipped for the second consecutive month, to 82.5 percent from 82.7 percent in September and 8.8 percent in August.



The fierce competition for labor is translating into accelerating wage gains. Average hourly earnings for all private workers increased by 0.4 percent last month, up from 0.3 percent increases in each of the previous two months. The year-over-year increase did slip from 5.0 percent to 4.7 percent, but that's still well above the 2-3 percent increases seen during most of the 10-year expansion leading up to the pandemic. It also keeps pressure on employers to raise prices to cover rising labor costs, which the Fed worries could lead to a wage-price spiral that would require much stiffer growth-destroying rate-hikes down the road. At this juncture, there's little sign that such a cycle is underway. But wage growth is lagging inflation and, if a sustained tight job market spurs workers to demand catch-up wage increases that employers can readily pass on to consumers, that vicious cycle would be set in motion.

One development that would restrain pass-through price increases is a more productive labor force. That would allow employers to boost wages by an amount equal to the productivity gain without raising prices or suffer a loss in profits. Since 1980, non-farm productivity has increased by an average of just under two percent a year. Had that pace been maintained, labor costs could increase by four percent and, after allowing for the two percent productivity growth, the Fed would be able to meet its two percent inflation target. However, neither side of that equation is close to being met. Productivity over the past year ranks among the weakest on record and wage growth has far exceeded its 40-year average of 3.5 percent. Average hourly earnings for non-management workers increased by six percent in the third quarter from a year ago.



To be fair, the productivity slump over the past year is a shock-related anomaly, as supply shortages linked to the pandemic and the war in Ukraine have drastically curtailed output. At the same time, companies have aggressively ramped up hiring and worker hours to keep up with surging demand ignited by outsized fiscal and monetary stimulus. That combination of suppressed output and bloated working hours is a sure-fire recipe for depressed productivity. What's more, the gap between worker earnings and productivity growth over the past year is the widest since the early 1980s when, not coincidentally, inflation was surging and the Fed was clamping down hard on the monetary brakes.

Clearly, it will not be long before employers realize they have too many workers for the amount of output being produced. Just how an equilibrium is restored will be crucial to the economy's performance – and the Fed's policy moves – over the coming months and quarters. The best-case scenario in the eyes of policymakers would be for supply in both the labor and product markets to grow quickly upward to meet demand. That means the labor force participation rate needs to pick up, easing the worker shortage that is driving up wages. Likewise, supply-chain disruptions that are crimping production and creating product shortages need to ease, something that is hobbled by external forces such as Covid-related factory lockdowns in China, the war in Ukraine and drought conditions in the U.S.

While significant progress on the product supply front has been made – logjams at major ports have eased considerably, delivery times are shortening and many retailers have a surplus of inventories – the Fed still has work to do to cool off demand. Understandably, some Fed officials are concerned about the lagged effects of the aggressive rate hikes already put in place. The housing market has already fallen by the wayside and the collateral damage to consumption is yet to be determined. Unless the next jobs report produces an upside surprise, we suspect that the Fed will dial back the next rate hike in December to 50 basis points but continue lifting it until it reaches five percent next year. The steep rise in borrowing costs, along with the depletion of excess household savings accumulated over the past two years, should be enough to throttle back demand and stifle the economy's growth engine, bringing on a recession in early 2023. At that point, inflation fever should break, and the Fed can only hope that it happens before millions of workers lose their jobs.