Bridgewater®
Daily Observations
November 7, 2022

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The Labor Market Has Held Up So Far; That Isn't Likely to Last

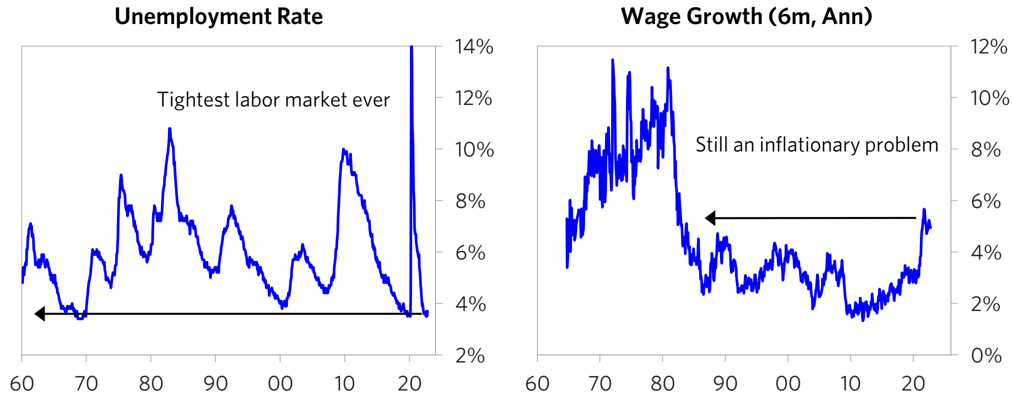
The Fed has likely already done enough to engineer a recession. Waiting for confirmation from a big drop in inflation (which lags growth) makes it more likely that the tightening will be even larger than what is needed, leading to a material contraction.

What do we make of the employment report? The US economy has been fine in recent months, reversing the slowing we had seen in the first half of the year. The GDP print for the third quarter was fine, consumer spending has been fine, timely surveys like the ISM have been fine. Only housing has been weak so far. The employment report on Friday is roughly in line with what you'd expect to see given what is happening in the economy, as employment lags conditions by at least a month or two. Employment is still growing moderately: non-farm payroll growth was strong and likely overstated, while the volatile and less reliable household survey was weak, and the ISM survey pointed to a stall. Reality is probably somewhere in between. The uptick in unemployment looks mostly like noise—while there have been some layoffs in industries that saw the largest run-ups, initial jobless claims suggest that about as few workers as ever are being let go. Wage growth remains too high for the Fed's comfort. This is still the tightest labor market ever, which in turn supports wages and inflation. It will take a recession to change that. The Fed seems determined to see clear evidence of a weaker economy and falling inflation before pivoting, making sure that equities don't rally and reverse the effects of the tightening.

Why haven't we seen broader weakness yet? We were early in expecting unemployment to start rising a few months ago. Clearly, we underestimated the resilience of household balance sheets (enabling consumers to accelerate borrowing and dissaving), and we continue to wrestle with how much further support this could provide. Moreover, over the last few months, the economy has benefited from additional cushions: a sharp decline in gasoline prices (freeing up spending for other goods and services) and a bounce in equity prices.

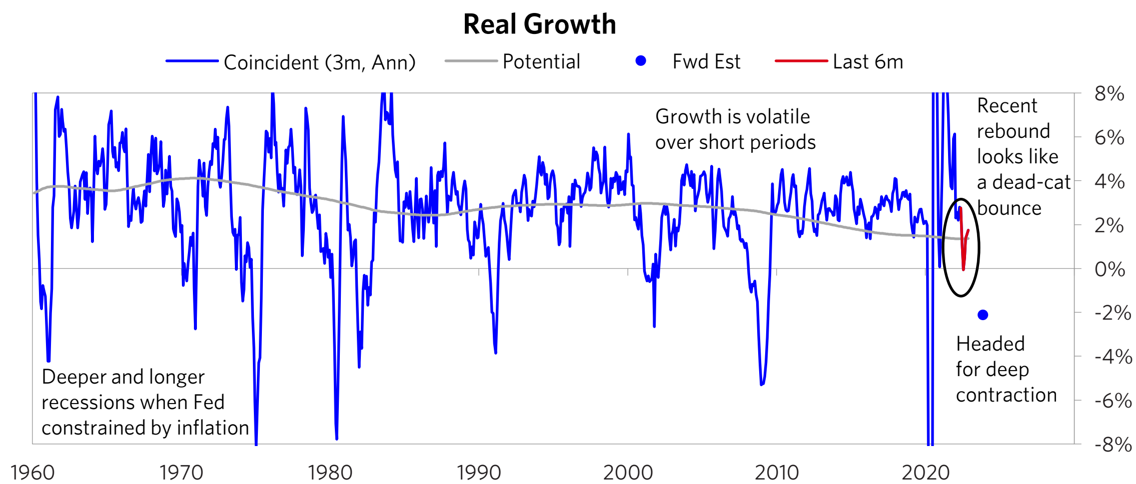
Do we still expect a deep recession in the next year? Yes. The Fed seems determined to keep going until it gets what it wants. The additional tightening in the last few months has been huge and has not yet flowed through to the economy. The tightening to date is the largest in 40 years, and if you take the speed into account, it is now on par with what Volcker did. We are already seeing a crack in residential construction and home prices. The pop we saw from rising consumer borrowing and falling savings rates is not repeatable, and, if anything, net borrowing is likely to slow in response to higher rates, with a big flow-through to growth, employment, and incomes. Wealth, including home values, is down. Almost everything is pointing to a material slowing from here.

We begin with some perspectives on where the economy has been recently, before exploring in more detail why we still see it poised for a contraction and what's driven the dead-cat bounce of the last few months.



Wage growth is based on a blend of average hourly earnings and the Employment Cost Index.

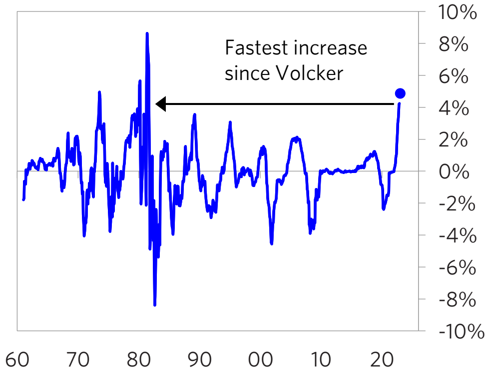
The chart below puts the bounce in the US economy over the last few months in context. It isn't what we expected. But it is also not that unusual to see short-term wiggles in growth. A bear market rally and lower gasoline prices were meaningful supports over the last few months.



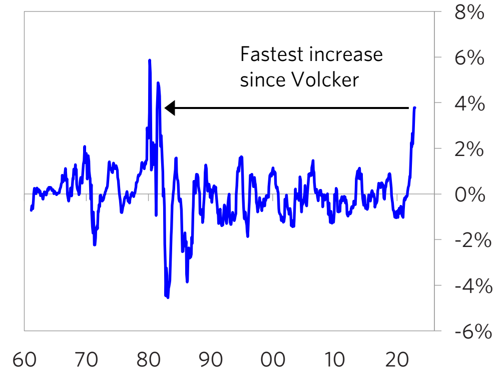
It Is Hard to Overstate How Large the Tightening Has Been

In its effort to bring inflation back to target, the Fed has been tightening at the fastest pace seen since inflation was last this high. The increase in rates over the last year is more than what's typically been enough to tip the economy into recession. The equity sell-off is already substantial and will drag on households' willingness and ability to spend going forward, and, as we discussed in a recent *Observations*, conditions don't yet look consistent with a bottom; we think the drawdown will deepen as the implications of the coming recession get priced into earnings expectations.

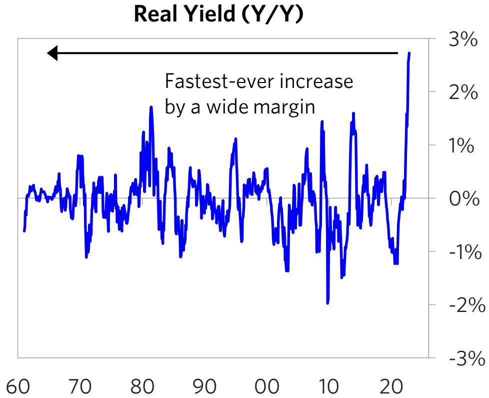
Short Rate (Y/Y) with Disc Peak



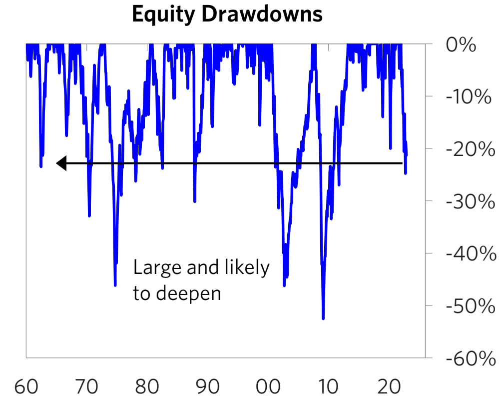
Mortgage Rate (Y/Y)



Real Yield (Y/Y)

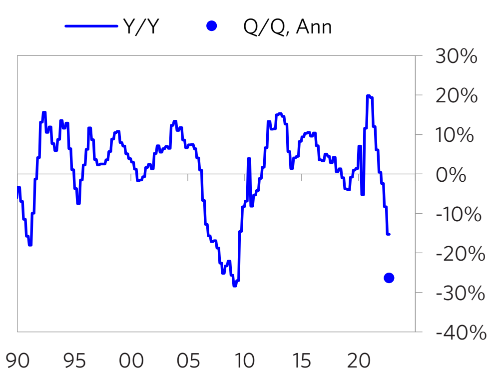


Equity Drawdowns

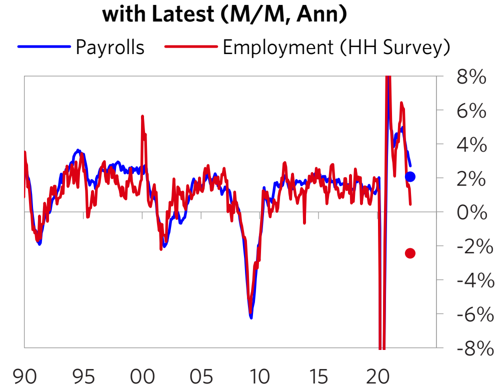


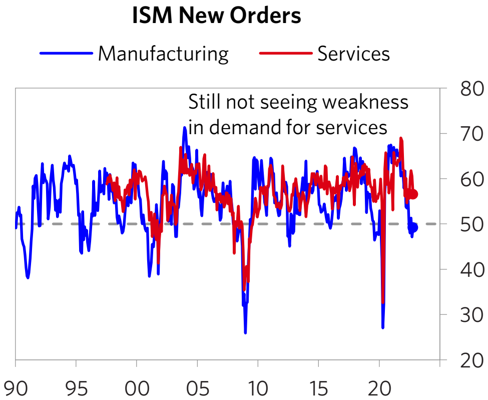
So far, we're seeing only limited signs of this tightening biting the real economy. Weakness is most pronounced in housing, which is most directly exposed to rising rates. Manufacturing is experiencing a continued rotation of demand back to services, but aggregate demand growth remains strong. The BLS household survey and the ISM survey of businesses suggest that the slowdown in hiring may already be here, though these tend to be less reliable than the payrolls measure.

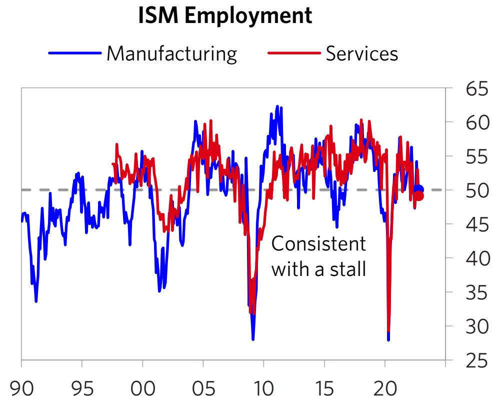
Real Resi Fixed Investment Growth



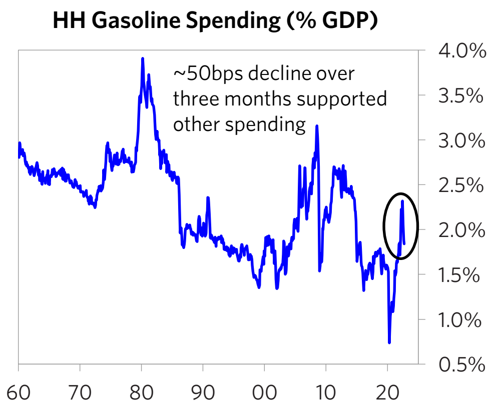
Employment Growth (6m, Ann)
with Latest (M/M, Ann)

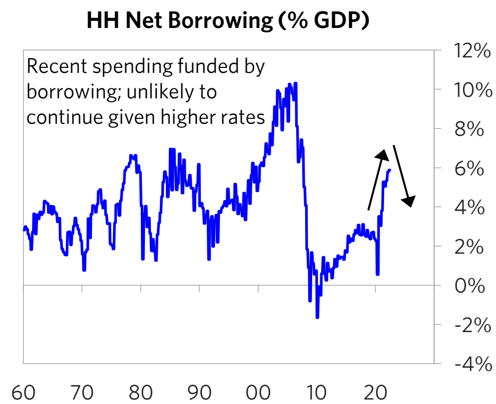






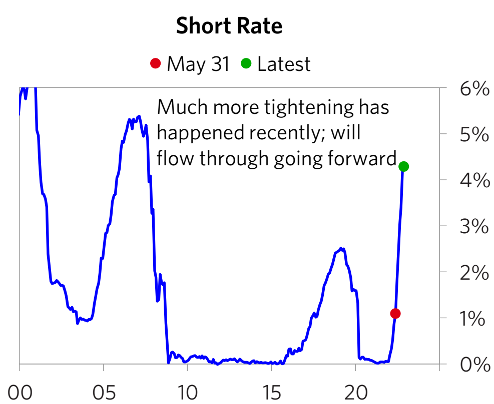
The resilience of demand has been driven in large part by temporary factors. Falling gasoline prices were a significant support to households over the summer, allowing them to shift spending to other goods and services. While some further softening is priced into the futures curve, declines at this pace are unlikely to be repeated. Households have also been borrowing and dissaving rapidly to sustain their spending. With rates now much higher, we see this as likely to turn over.

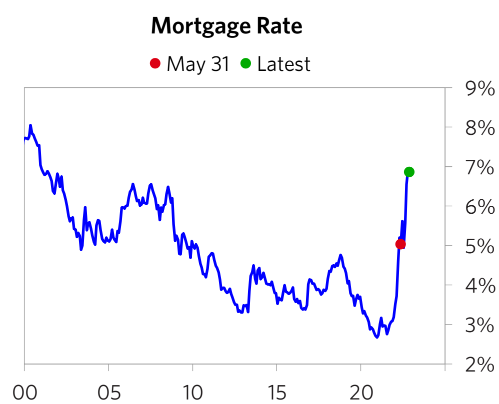




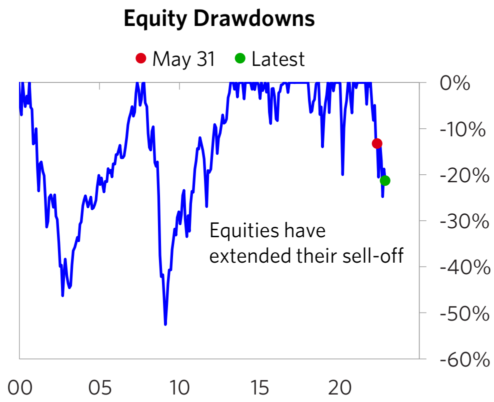
Much of the Tightening Has Taken Place in Recent Months—It Is Still Too Soon to See the Effects

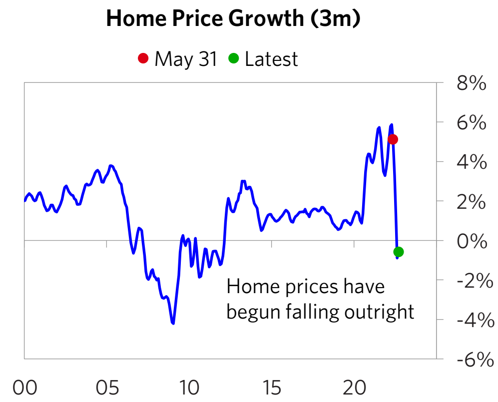
A lot of additional tightening has taken place over the last few months. While a lot of this tightening was already priced in at the beginning of the summer, most of the actual increase in short rates has come more recently and has yet to fully flow through to the economy. Expectations for future tightening have also increased substantially, driving up longer-term borrowing rates, including mortgage rates.





This has already flowed through to much more pronounced weakness in assets, hitting household net worth, which will also drag on spending going forward.

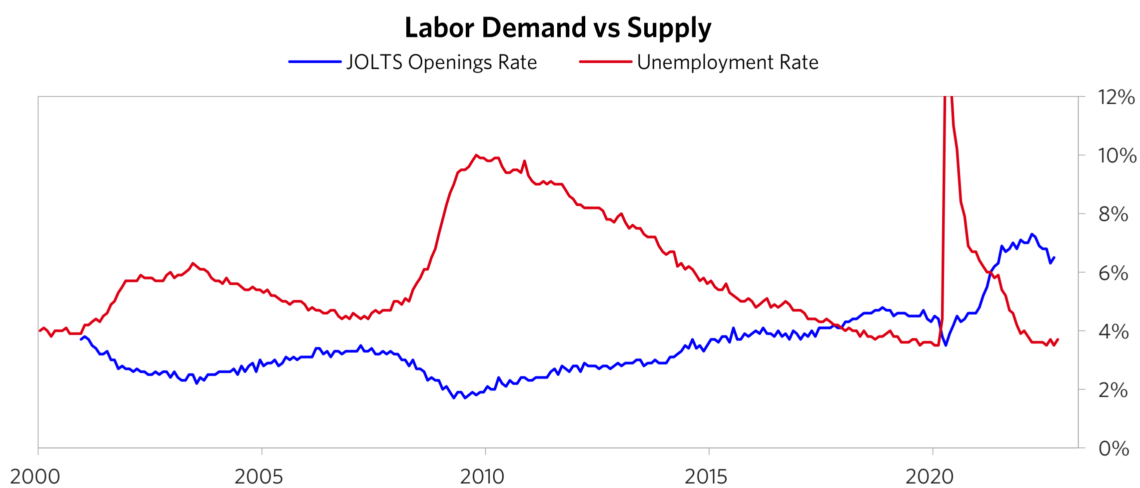




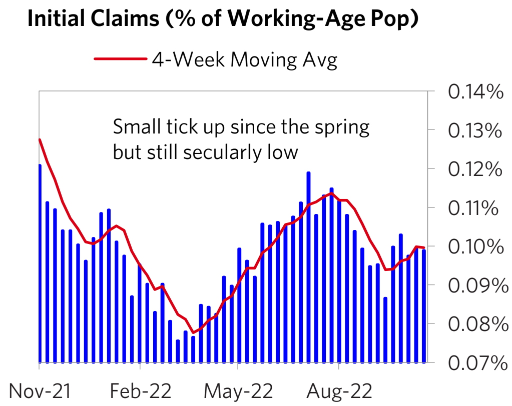
Appendix: Additional Detail on the Employment Report

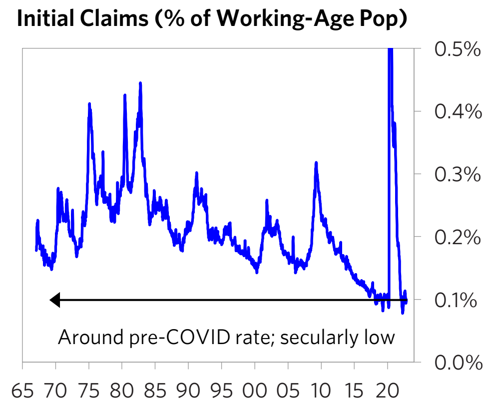
Below, we show some additional perspectives on US employment. The key takeaways are described above.

While it's softened a bit, this is still an extremely tight labor market. Given the huge, persistent backlog of unfilled job openings, the unemployment rate understates this tightness.

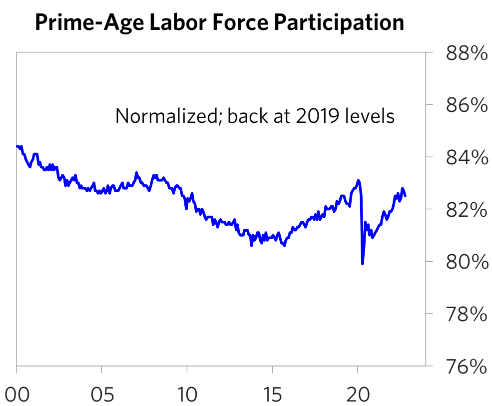


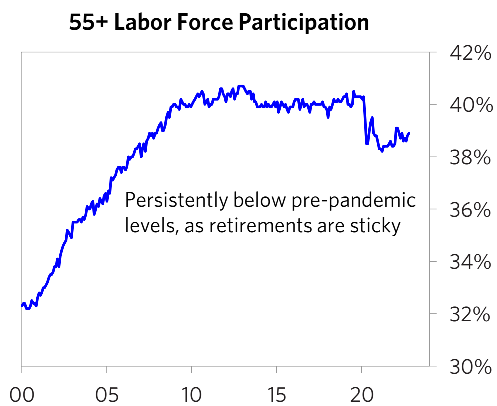
Initial jobless claims, a proxy for layoffs, have remained extremely low, suggesting that even the small reported uptick in unemployment is more noise than a true reflection of workers being let go and unable to find work.





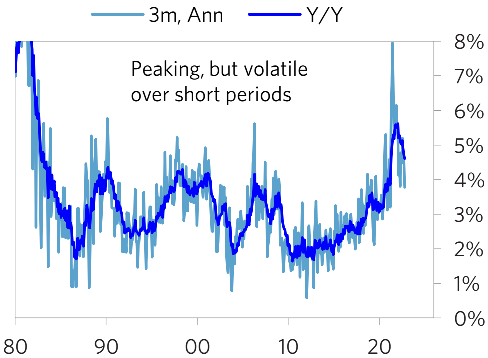
The supply of labor remains constrained, and most of the support from workers returning to the labor force looks to be behind us. Prime-age adults are about as likely to be working or looking for work as they were before the pandemic. While some older adults have returned to the labor force, the vast majority of the retirements accelerated by the pandemic look to be permanent. And the secular backdrop remains one of an aging population and slow labor force growth.



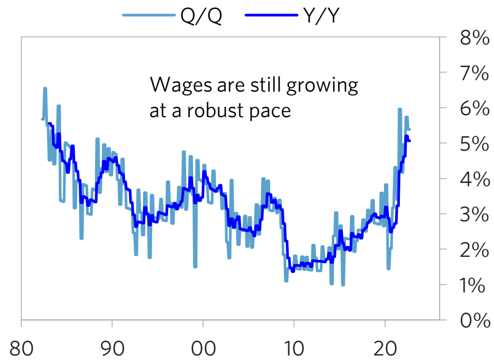


There's been a growing divergence between measures of wages, but looking across them, the picture adds up to persistently high wage growth of around 5%—too high for the Fed's comfort. The weakest read comes from average hourly earnings, the headline measure in the monthly employment report. This measure points to a meaningful slowing in wage growth this year (though still to a pace in line with the tops of cycles since the early 1980s). Some of this is likely due to compositional effects, as more of the net new hiring this year has been of new entrants to the workforce or workers taking second jobs to supplement their income, often at below-average wage levels. Measures that more rigorously control for composition show much less slowing in wage growth. Looking ahead, while wage growth is likely to moderate over time as the economy weakens, there is still some pent-up strength, as the starting point for the labor market is so tight and there is room for existing employees' raises to catch up to the large gains achieved by those who have switched jobs over the last two years.

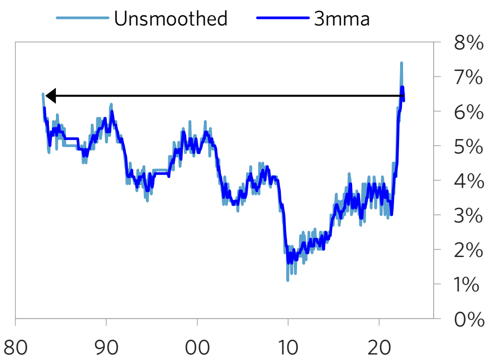
Average Hourly Earnings



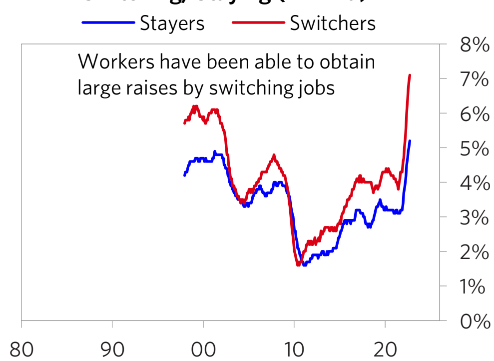
Employment Cost Index: Wages and Salaries



Atlanta Fed Wage Growth Tracker



Wage Growth by Job Switching/Staying (12mma)



Average hourly earnings are shown adjusted for distortions during the pandemic.