PORTFOLIO ANALYSIS & CONSULTING

Charts and Smarts®
November 2023

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After a blowout Q3 saw real GDP grow 4.9% over the quarter, consensus estimates seem to unanimously be pointing to a marked slowdown in growth as we close out the year. While it should be no surprise that growth will slow after such a robust quarter, that consensus looks likely to be offside on expectations for growth over the next couple of quarters. The summer months saw a steady grind higher in estimates for Q3 growth as forecasts chased the wave of strong incoming data ever higher through the quarter, and we could once again be setting up for a similar dynamic in the current and coming quarters. The robust growth witnessed during the third quarter was the result of a perfect confluence of fading pandemic bullwhip echo effects combining with a peak in 2022’s growth headwinds flipping to 2023’s tailwinds. Consumer spending was robust while the housing drag finally abated, inventory restocking picked back up, and government spending remained elevated behind strong federal, state, and local expenditures. Yes, growth is likely to moderate from a breakneck pace, but underlying growth momentum remains firm as final sales to private domestic purchasers, the best indicator of forward growth, grew 3.3% over the quarter. As a result, consensus estimates, which see tepid growth in the first half of 2024 followed by more robust growth in the second half of the year, likely need to be flipped, with stronger growth pulled forward and weaker growth pushed further out. While for some investors this is sure to trigger PTSD of the aggressive rates market repricing of the past few months, the current environment is very different. Slowing nominal growth is likely to continue as inflation cools and improving productivity will serve as a powerful buffer to absorb robust growth without a subsequent increase in inflation. Growth is no longer the Fed’s enemy.

Source: Portfolio Analysis & Consulting, Bloomberg.
After a wave of encouraging data and decisions – from the Employment Cost Index and soft PMI data to less aggressive coupon Treasury issuance and a markedly more dovish tone from Fed Chair Powell – the October payrolls print provided a further impulse to the narrative shift and spurred another massive rally in rates. While most of the attention is placed on the headline jobs number and wages, it’s the change in aggregate earnings growth for US workers that is perhaps the most important data print for markets. The growth in aggregate earnings, or the product of payrolls times average hourly earnings times average hours worked, fell to 5% with the most recent print, completing a long and steady journey back to the pre-pandemic range. Incomes are the driving force behind consumption, and with consumption representing nearly 70% of the US economy, nominal aggregate earnings serve as a reliable indicator of nominal consumption and GDP growth. Labor markets, in aggregate, are finally back to a range that is consistent with the Fed’s 2% inflation target, as payrolls growth has moderated, wage growth continues to cool, and hours worked have retraced back to pre-pandemic levels. Labor markets remain resilient, but tightness has certainly eased. While the Fed has long leaned on excessively tight labor markets as a justification to maintain a hawkish bias due to potential inflationary risks from elevated wage growth, that is no longer the case. Labor market tightness is no longer a valid justification to remain hawkish as the balance of risks between the Fed’s dual mandate has largely come back into equilibrium. The doves are firmly in control and the pause in rate hikes we’ve seen since the July meeting looks set to continue into 2024.

Source: Portfolio Analysis & Consulting, Bloomberg.
While signs of the labor market returning to a sustainable equilibrium was certainly part of the driver behind the rally in rates we’ve seen grip markets over the past few weeks, markets love to extrapolate and overshoot. Noise within this print certainly provided reason to extrapolate slowing into outright weakness and fuel what may be an ironic growth scare as growth is likely to surprise to the upside. The headline payrolls figure came in notably weaker than expectations, with the economy adding just 150,000 jobs in October against expectations for 180,000 jobs. But given the timing of the survey period for the print, the UAW strikes played a key role in that downside surprise. To be included in the establishment survey one must be employed and actively at work. October saw 96,000 workers not at work due to labor disputes, the highest print since the 1997 UPS strikes. That saga saw payrolls growth fall from a pace of about 300,000 jobs created per month to an outright contraction of 20,000 jobs at the peak of the strike in August 1997. With the resolution of the strike, September saw a surge of 495,000 jobs before resolving back to around pre-strike levels over the next few months. As we’ve now seen resolution to the UAW strikes as well as Hollywood’s writers’ and actors’ strikes, we are likely to see a similar reversal in the November data as striking workers are again included in the headline figure before the data gives way back to the underlying trend. One which continues to point to a resilient labor market.

Source: Portfolio Analysis & Consulting, Bloomberg.
While there were reasons for optimism under the soft headline data, there was one data point, in particular, that helped to fuel fears of cracks forming in labor markets: The unemployment rate. While the U-3 unemployment remains below 4%, suggesting a strong labor market, it has crept higher over the course of this year and, at 3.9%, now stands 50 basis points off the cycle lows of 3.4% reached back in April of this year. Why all the concern around a 50 basis point move? In short, the Sahm Rule. The rule, developed by former Fed staffer Claudia Sahm, is more of an empirical relationship that notes any time the 3-month average of the unemployment rate rises 50 basis points above its trailing 12-month low, the economy was already in a recession. While on a single month basis we’ve now reached that threshold, it’s important to note the rule actually requires the 3-month average to breach a 50 basis point rise. That’s just the fuel the market needs to ramp up bearish extrapolations – just string together two more 3.9% prints and the rule triggers and the long-awaited recession is finally here! No wonder Jobs Day saw 10Y yields rip 20 basis points lower. Indeed, when it comes to unemployment, in particular, the rule is an acknowledgement that nonlinear risks exist. Once momentum begins with rising unemployment, it can snowball into a much greater move – hence Sham’s proposal to automatically send out stimulus checks to families to support demand and short circuit that potential negative feedback loop of higher unemployment curtailling demand and driving a further rise in unemployment. But, given the unique dynamics of this cycle, perhaps we should appreciate the potential that the rule is an empirical observation, not a law of nature. We’ve already seen plenty of examples where traditional economic models didn’t hold up through this unprecedented crisis and recovery, and there’s room for more.

Source: Portfolio Analysis & Consulting, Bloomberg.
Even if there are reasons to view traditional economic models and relationships with healthy skepticism, given the unique economic environment we find ourselves in today, the recent rise in the unemployment rate is certainly something to closely monitor. That said, it’s important to note that unemployment can rise for good and bad reasons. As the labor market has normalized, not only have quit rates normalized, but we’ve also seen a notable moderation in hiring rates. The result is longer matching times for potential candidates to find jobs, a theme seen clearly in the increase in the U-1 unemployment rate, which tracks long-term unemployment of greater than 15 weeks, from 1.1% to 1.4%. On the other side of the equation, however, layoff and discharge rates have risen, though still remain well below pre-pandemic levels. Putting the whole picture together, we can see a more encouraging story playing out in the rise of the unemployment rate from the April lows. October saw a notable increase in the unemployment rate driven by temporary or permanent layoffs, but looking back over the summer months, we can see a substantial driver of the increase in unemployment was the expansion of the labor force as new entrants and reentrants came into the ranks. All told, nearly 35% of the rise in the unemployment rate off the recent lows has been driven by positive labor supply dynamics – a good reason for the rise in the unemployment. To be sure, it’s worth noting that temporary and permanent layoffs now represent a larger share of the rise in the unemployment rate, but let’s not get carried away with a good story just yet. The rising unemployment rate is something that bears close monitoring, but a meaningful share of that rise is due to a strong labor market luring back potential workers, not because the labor market is imminently on the verge of a negative feedback loop.

Source: Portfolio Analysis & Consulting, Bloomberg. The decomposition of changes in the unemployment rate does not sum to the headline change in the unemployment rate due to differences in seasonal factors applied to each series. Positive Factors include new entrants and reentrants. Negative Factors include temporary and permanent layoffs. Neutral Forces include workers completing temporary jobs and changes in the size of the Civilian Labor Force.
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Adtrax: 1438702.11.59
Expiration Date: 5/31/2024