

Policy normalization or labour market rescue?

Focus on the upcoming Fed easing cycle

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FLASH NOTE

SUMMARY

- A benign moderation in the labour market remains our base case. The recent increase in the unemployment rate, from a local trough of 3.4% in April 2023, to 4.2% in August 2024, was more supply than demand driven. The initial increase last year was due to a normalization in layoffs from extreme lows, and a fall in labour demand from extreme highs. The more recent increase came from workers entering the labour force and not finding jobs right away, itself reflecting weaker hiring rather than layoffs. Thus the unemployment rise through August appears different from the usual cyclical turning point a triggering of the Sahm rule would otherwise indicate.
- But with inflation concerns receding and the labor market having rebalanced, the Fed's current stance of monetary policy is too restrictive. A situation where labor demand is too weak to absorb the temporarily elevated growth in labor supply is a slow-moving issue that the Fed can likely deal with by easing policy.
- We do not see signs of a sharp rise in layoffs, or a deterioration in hiring that would call for an aggressive policy response. Barring a significant financial shock, we are sticking with our view of a policy normalization cycle starting with 25bps rate cuts in September, November, and December this year.
- However, risks of more front-loaded easing, meaning cuts in bigger increments and a faster return to neutral, are rising. If evidence of weaker labor demand, or increases in layoffs emerge, FOMC would react forcefully.
- The current environment of low hiring and low firing could be a fragile equilibrium because, first, it makes the labour market more vulnerable to shocks and, second, even if labour demand remains robust, the volatility and noise in monthly jobs growth will inevitably cause payrolls to print noticeably lower at times. A major concern is whether weak hiring will lead to labour cost cutting and widespread layoffs, triggering a negative feedback loop between job losses and reduced spending that would be hard for policymakers to counteract.

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- Fed funds futures are now pricing in around 32bps of rate cuts for September, but about 40bps for November and December each, reflecting the market’s view that the probability for the Fed to switch to larger cuts later on is high. Growth scare could persist for a while.

LOW HIRING AND LOW FIRING COULD BE A FRAGILE EQUILIBRIUM

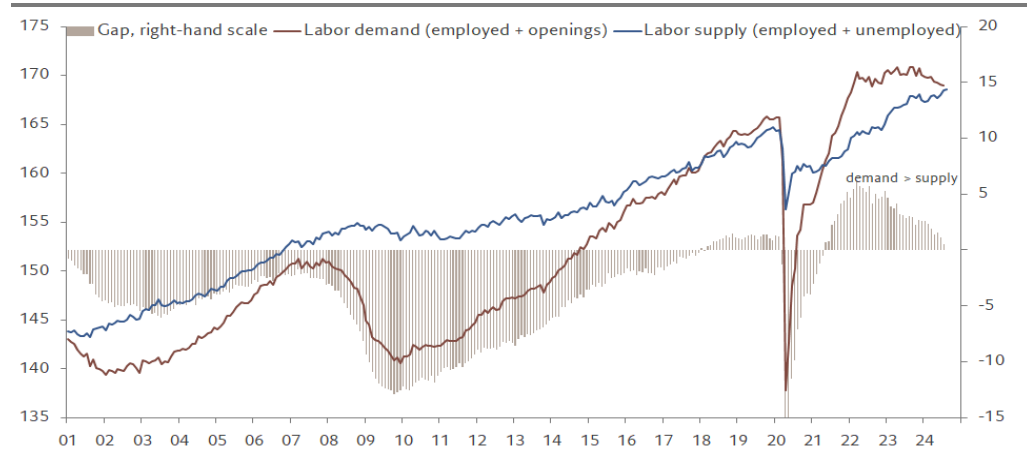
Whether the US labor market cooling is a step towards the elusive soft landing, or a step towards recession is key to determining the kind of easing cycle we’ll get in the coming months. A soft landing would lead to policy normalization, with rates being lowered gradually to neutral, whereas a recession or the need to rescue the labour market would see policy rates lowered in bigger increments and quickly to neutral or even below.

A month ago, after the July employment report, we argued that the data didn’t warrant a 50bps rate cut from the Fed in September, or an inter-meeting cut beforehand, but macro risks were building to the downside. The August employment report last Friday didn’t exactly settle the debate. Payrolls rebounded and unemployment edged lower, but hiring is clearly slowing.

The US labour market has rebalanced – supply has caught up with demand thanks to elevated immigration and higher participation from the prime-age work force, while labour demand has slowed as job openings declined meaningfully.

From a “glass half-full” perspective, this is a solid labour market with conditions resembling those in 2018. From a “glass half-empty” view, however, the trend is not your friend and the labour market has lost quite some momentum.

Chart 1: Labour demand and supply - level vs. momentum



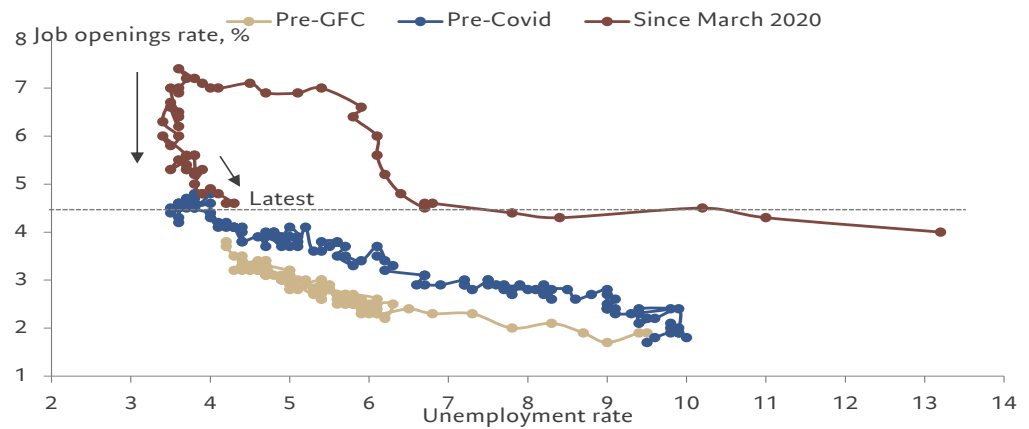
Source: Pictet Wealth Management, BLS, as of Sept 2024

Viewed through the framework of the Beveridge curve, which has been a more helpful guide this cycle than other models such as the Philips curve, the labour market is at an inflection point. The Beveridge curve normalized initially via lower job openings, but unemployment has also started to move up. Fed Governor Waller was prescient in predicting that the labour market can rebalance through lower job vacancies, with a relatively small increase in the unemployment rate. But Waller also

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pointed out that if the vacancy rate continued to fall below 4.5% (it stands at 4.6% today), there could be a significant increase in the unemployment rate.

Chart 2: Beveridge curve – job openings vs. unemployment



Source: Pictet Wealth Management, BLS, as of Sept 2024

So far, the cooling in the labour market should be viewed as softening but not deterioration. Payroll income growth, the main source of disposable income for households, has slowed to the middle of its pre-covid range, supporting slower, but still positive consumer spending.

Household balance sheets remain reasonably healthy in aggregate with high net worth from financial and real estate assets accumulation, manageable leverage, and rising but not surging interest costs.

However, low-income households’ finances are becoming stretched and they are clearly struggling – excess savings have been depleted, delinquency rates are rising, and interest burdens remain elevated due to a higher share of credit/auto debt vs. mortgages. This increases the vulnerability of the labour market to an unexpected adverse shock.

The labour market is not in recession, but it is in a fragile equilibrium with low hiring and low firing. Setting aside the drivers of the unemployment rate, the increase in the unemployment rate in itself reflects a demand-supply mismatch. The big question is whether weak hiring will precede labour cost cuttings and lead to widespread layoffs, tipping the labour market over.

Our view of a benign moderation in the labour market hinges on a mild slowdown in job gains and no significant pickup in layoffs, leading to only a small increase in the unemployment rate. Below we look in detail at recent labour market dynamics, and risks to our outlook.

HIRING HAS CLEARLY SLOWED

The slowdown in hiring is evident across employment data, surveys, and business reports. Nonfarm payrolls have slowed from 242k to 116k on a three-month basis since the beginning of the year (chart 3). Household survey employment is more volatile but has been running weaker than payrolls for most of the past year. Revisions

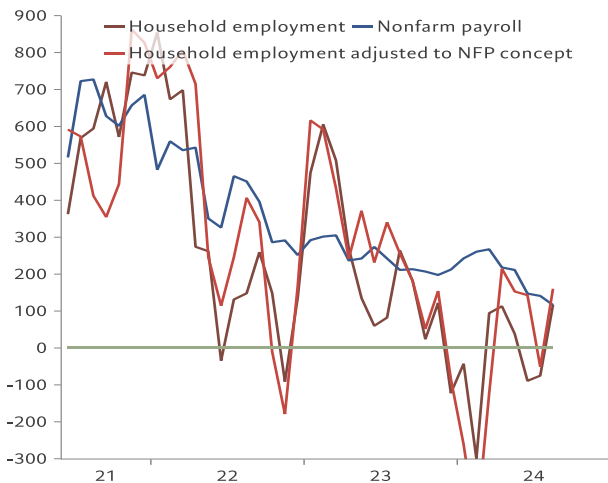
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to payrolls have been broadly negative, and job gains remain concentrated in a few industries (chart 4). The BLS’s preliminary estimate of benchmark revisions to NFP imply the level of payroll employment is 68k per month less from April 2023 to March 2024 than originally estimated, although these revisions likely overestimated the degree of weakness given under reporting of immigration and the likelihood of upward revisions in the final release.

The current level of job growth is below reasonable estimates of the breakeven rate for the labour market, which had increased due to the expanding labour supply (chart 5). But as labour supply growth slows, the breakeven rate is estimated to decline, meaning a slowdown in payrolls won’t necessarily translate into a further increase in the unemployment rate.

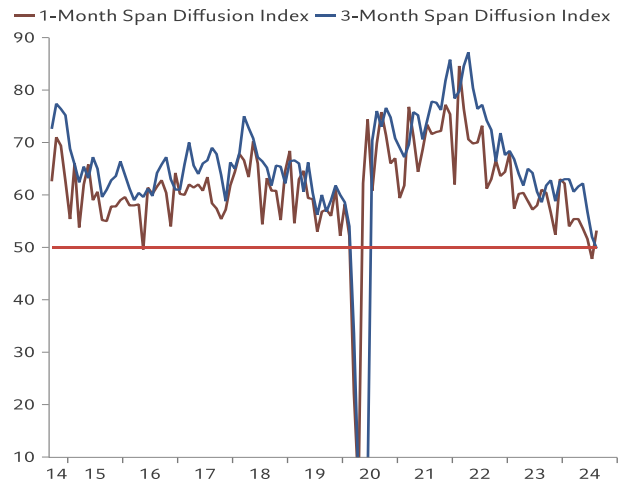
The post-pandemic labour market has gone from the Great Resignation to the Great Stay, and now things are not so simple any more - the job openings rate has dropped back down to pre-pandemic levels and those who lose their jobs are finding it increasingly difficult to secure new ones (chart 6).

Chart 3: NFP and HH Survey employment, 3mavg



Source: Pictet Wealth Management, BLS, as of Sept 2024

Chart 4: Nonfarm payrolls diffusion index*

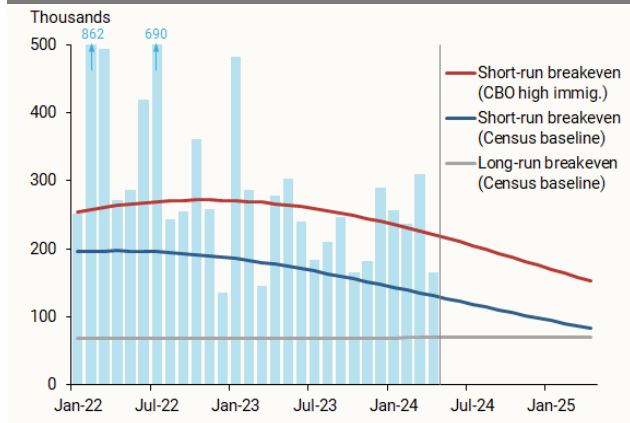


Source: Pictet Wealth Management, BLS, as of Sept 2024.

*50 percent indicates an equal balance between industries with increasing and decreasing employment

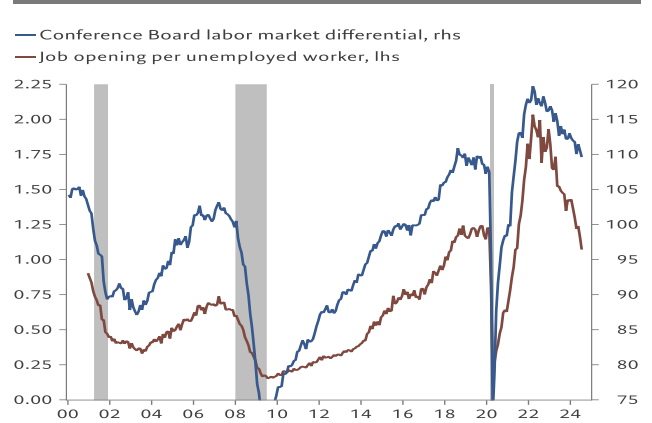
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Chart 5: Short-run monthly breakeven employment growth*



Source: Pictet Wealth Management, BLS, [SF Fed](#), as of July 2024. * A pace of job creation that absorbs new entrants to the workforce and keeps the unemployment rate constant

Chart 6: Job openings to unemployment ratio, and labour market differential*



Source: Pictet Wealth Management, BLS, as of Sept 2024. *the labour market differential is households' perceptions of how hard it is to find a job

LAYOFFS REMAIN LOW; UNEMPLOYMENT RISK SKEWED TO THE UPSIDE

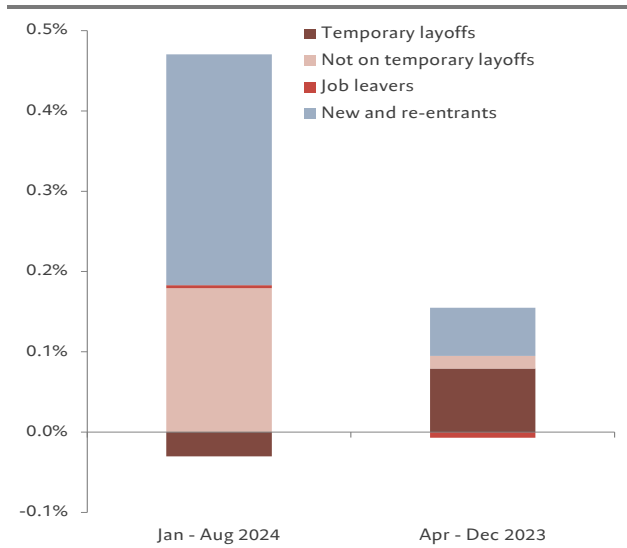
The recent increase in the unemployment rate, from a local trough of 3.4% in April 2023, to 4.2% in August, was more supply than demand driven. The initial increase last year was due to a normalization in layoffs from extreme lows, and a fall in labour demand from extreme highs (chart 7). The more recent increase is from workers entering the labour force and not finding jobs right away, itself reflecting weaker hiring rather than layoffs. Besides a boost from immigration, the prime-age labour force participation rate is close to its historic high and the employment-population ratio stayed at the highest level since the early 2000s. In fact, permanent job losers have declined as a share of unemployed since the beginning of the year. Thus the unemployment rise through August appears different from a usual cyclical turning point as a breach of the Sahm rule would otherwise indicate.

There has been a small increase in layoffs off of extreme lows over the past couple of months, but these do not appear substantial. Anecdotes from the Fed's Beige Book, surveys of firms, earnings reports indicate outright employment reductions are also generally low. Initial jobless claims, the JOLTS layoffs rate, and the magnitude of layoffs implied by state-mandated WARN notices also remain low¹.

¹ Although WARN laws will not apply for small businesses and in some states may not apply for layoffs that are initially intended to be temporary but later become permanent

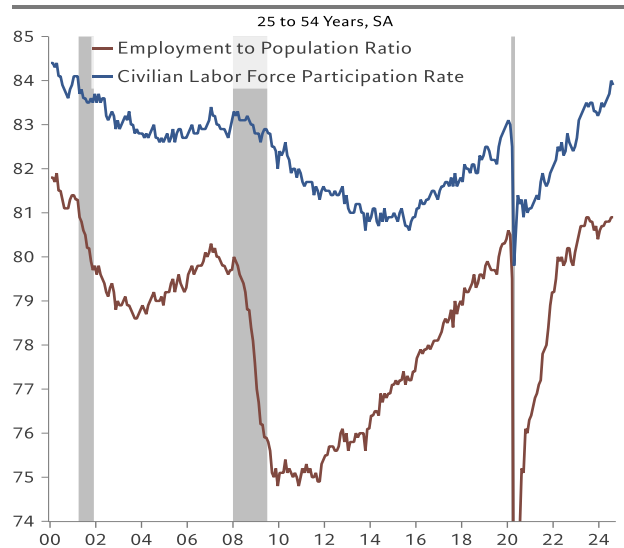
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Chart 7: Rise in the unemployment rate by reason, 2024 vs. 2023



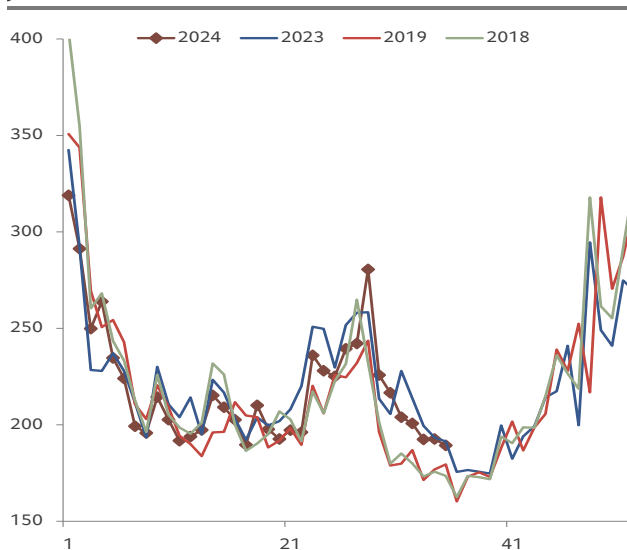
Source: Pictet Wealth Management, BLS, as of Sept 2024

Chart 8: Prime-age labour force participation and employment ratios



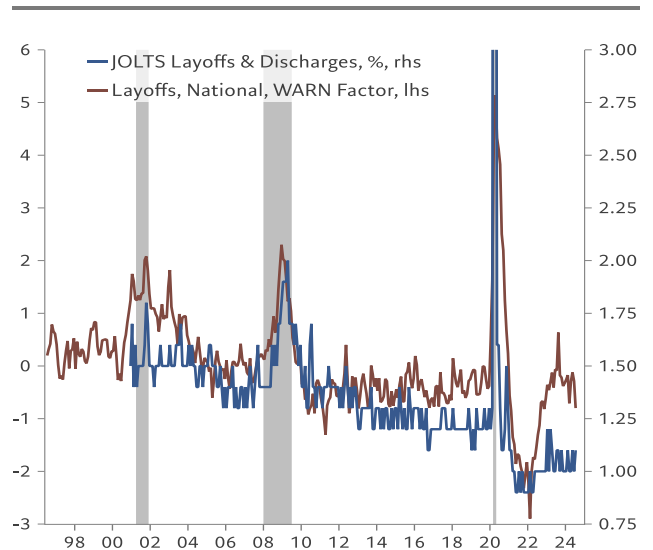
Source: Pictet Wealth Management, BLS, as of Sept 2024

Chart 9: Initial jobless claims, not seasonally adjusted



Source: Pictet Wealth Management, DoL, as of Sept 2024

Chart 10: Layoffs are higher from troughs but remain low



Source: Pictet Wealth Management, BLS, as of Sept 2024

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