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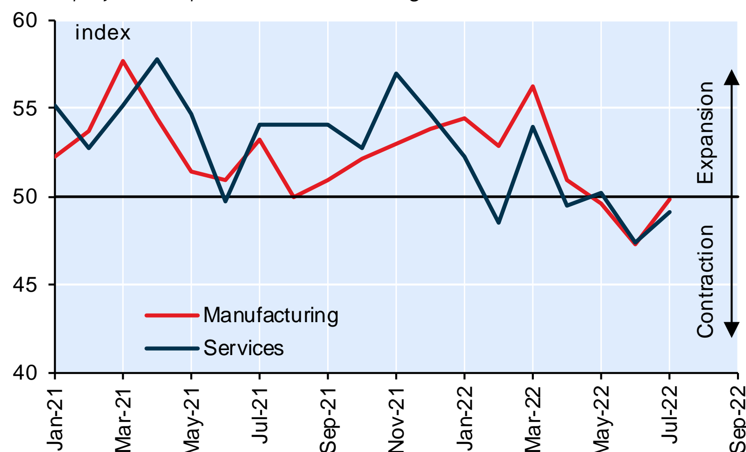
Labour market leeriness

By Jocelyn Paquet & Taylor Schleich

Rates are rising, financial conditions are tightening, GDP growth is slowing (technical recession, anyone?), sentiment is souring, and labour markets are… tighter than ever and still roaring along? That's certainly the impression you'd get from the July nonfarm payroll report last month, which showed the American economy adding an eye-popping 528K jobs despite the gloomy backdrop. The extremely tight labour market has complicated the job of the Federal Reserve. With inflation still raging at uncomfortably high levels, the pivot that markets had been increasingly banking on is unlikely to materialize unless there is major economic damage (or a precipitous return to 2% inflation). That, as Jerome Powell candidly noted last week, will likely require a deterioration in labour markets. That may not be too far off in our view as we posit that the U.S. labour market is on much less solid footing than you'd think from a cursory glance at nonfarm payroll gains. Allow us to explain…

Business sentiment on hiring intentions has been deteriorating all year. After remaining in expansionary territory for the vast majority of 2021 and early 2022, the employment diffusion indices for services and manufacturing have fallen into contraction (i.e., below 50). These aren't perfect measures by any means, but they've historically tracked actual employment changes reasonably well.

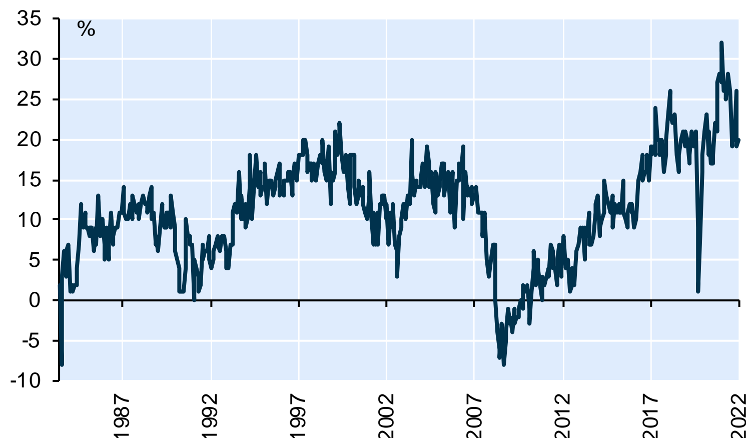
Chart 1: ISM employment indicators in contraction zone
ISM employment reports on manufacturing and services, since Jan-2021



Source: NBF, Bloomberg

Other soft indicators are telling a similar story. Conference Board data is suggesting a moderation in net hiring intentions among small businesses.

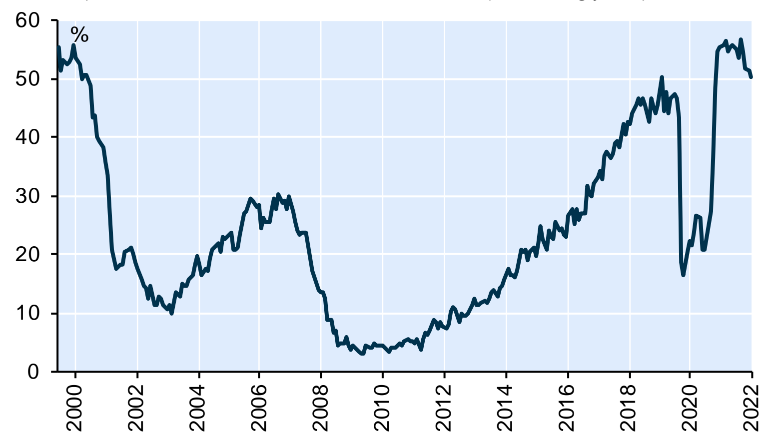
Chart 2: Hiring slowdown not only seen in jobs report
NFIB Small Business Optimism Index: Net hiring intentions



Source: NBF, Bloomberg | Note: Index reflects % of firms planning to increase employment in coming months

Everyday Americans have also noticed weaker conditions. The percentage of respondents to the Conference Board's survey who see jobs as 'plentiful' has fallen non-trivially, though it remains at an elevated level. The New York Fed's Survey of Consumer Expectations likewise signals a deterioration of the jobs outlook.

Chart 3: Jobs report isn't alone in showing hiring slowdown
% of respondents to the Conference Board survey deeming jobs plentiful

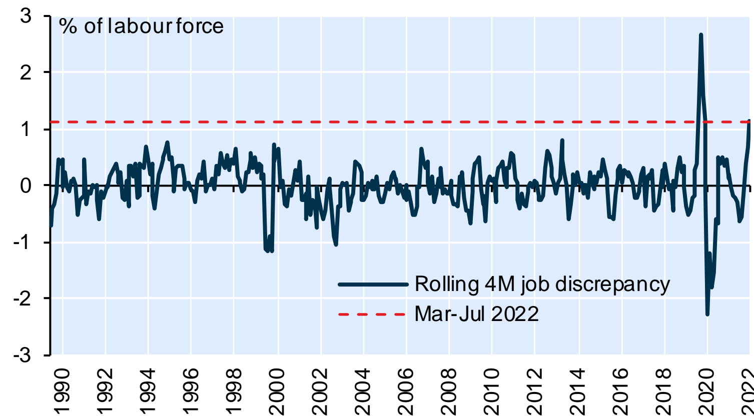


Source: NBF, Bloomberg

If the labour market backdrop is weakening, why isn't the hard labour market data reflecting it? Well, it is… sort of. While the establishment survey continues to chug along and add jobs at a still-impressive pace, the household survey has been far more consistent with weaker soft data. Indeed, the 1.7 million jobs added over the past four months as per the NFP report stands in stark contrast with the 0.2 million job *loss* via the household survey. The gap over the past four months is among the largest we've seen on record (save for some wicked distortions during the spring of 2020). Given that these two series are *effectively* reflecting the same thing, these discrepancies are not often sustained for long periods. It follows that they should be expected to converge over the coming months.

Is there a fundamental explanation for the discrepancy? Yes and no. Differences in employment concepts between the two surveys do help to partially narrow the gap. However, even after adjusting for multiple jobholders (these count twice in the establishment survey but once in the household survey), self-employed (not included in establishment survey) and agricultural workers (not included in establishment survey), a major gap remains. The BLS also publishes a series that is meant to more fully reconcile differences in survey concepts, but this also doesn't fully explain the differences.

Chart 4: Discrepancy in NFP vs HH survey job creation
Difference in 4M job creation as a share of labour force: NFP vs. HH survey



Source: NBF, BEA, Bloomberg | Note: Calculated as 4M job creation via establishment survey less 4M job creation via household survey, divided by labour force

Table 1: NFP-Household survey divergences often reverse
*Diff. in NFP & HH Survey job growth 3M/6M/12M after NFP outperformance**

Month	Next 3 months	Next 6 months	Next 12 months
Jan-1973	-560	-842	-911
Apr-1980	-572	-443	-1389
Sep-1981	-163	-651	-1734
Sep-1984	30	-1	534
Jun-1985	-566	-561	-1375
May 1988	-278	-153	144
Jun-1995	-22	468	403
Oct-2013	-1105	-877	-1112
Average	**-405**	**-383**	**-680**

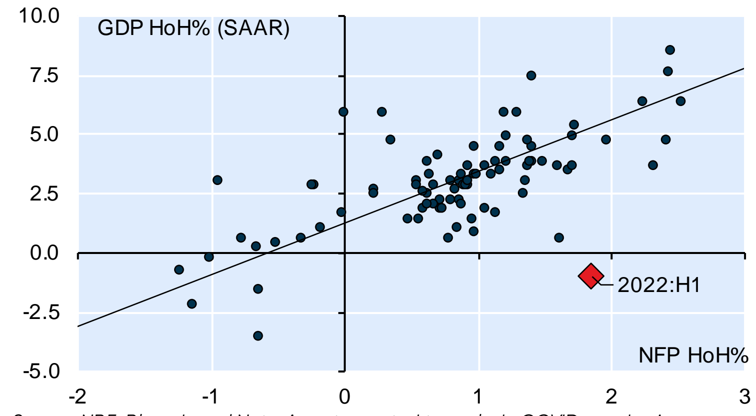
*Source: NBF, Bloomberg | Note: *Outperformance period defined as NFP employment outpacing Household survey job growth by >0.75%-pts of labour force over 4-month period. Table excludes pandemic period.*

The Fed has also taken notice. As FOMC participants discussed at their late-July meeting (before July's jobs data was published):

> "Participants remarked that the strength of the labor market suggested that economic activity may be stronger than implied by the current GDP data, with several participants raising the possibility that the discrepancy might ultimately be resolved by GDP being revised upward. Several participants also observed, however, that the labor market might not be as tight as some indicators suggested, and they noted that data provided by the payroll processor ADP and employment as reported in the household survey both seemed to imply a softer labor market than that suggested by the still-robust growth in payroll employment as reported in the establishment survey."

It's not just the jobs data that are seemingly inconsistent. Purported employment growth in the first half of the year was out-of-sync with first half GDP data. As one might expect, GDP growth and employment growth have traditionally been positively correlated. An expanding economy is usually fueled by additional labour inputs. Not in the first half of 2022, however. The 2.8 million jobs added (as per the establishment survey) compares to –1% annualized growth in the same period—a clear outlier.

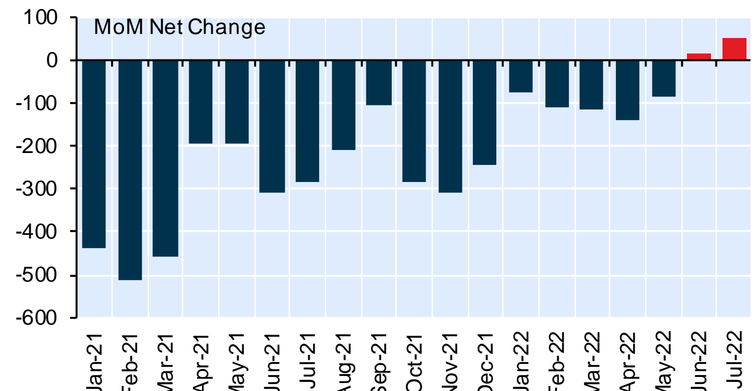
Chart 5: Employment-GDP pattern is off-trend
Semi-annual % changes in U.S. GDP and NFP employment, since 1976



Source: NBF, Bloomberg | Note: Axes truncated to exclude COVID pandemic

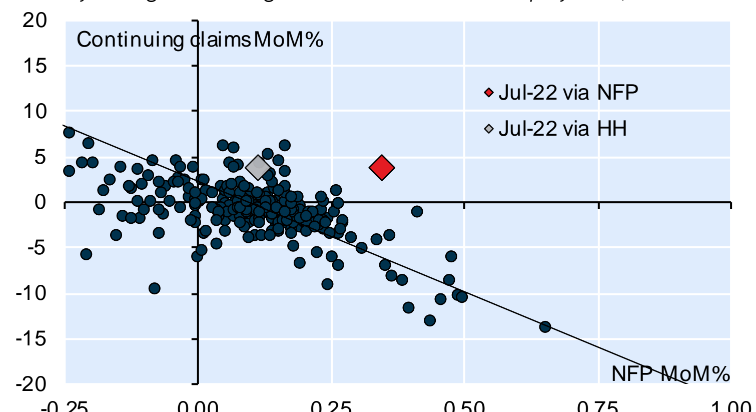
Claims data tells a similar story. Initial claims have been ticking higher for months. This could be overcome by claimants quickly finding work again but continuing claims, which took longer to reverse its steady decline lower, edged up in June and again in July. Based on the past two decades of claims data (and consistent with intuition), the increase in continuing claims in July would've been consistent with job losses—certainly not the 528k net new jobs that was reported. The household survey's 179k employment increase is closer in line with continuing claims data.

Chart 6: Continuing jobless claims are ticking higher
Change in average monthly continuing claims, since Jan-2021



Source: NBF, Bloomberg

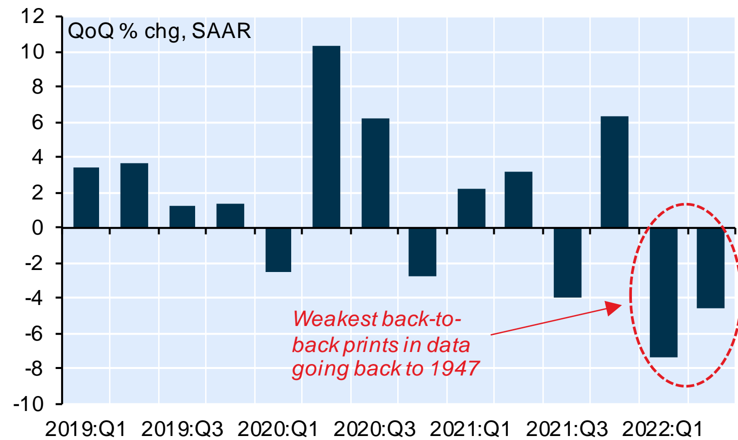
Chart 7: HH survey a better reflection of continuing claims
Monthly changes in average cont. claims and NFP employment, since 2000



Source: NBF, Bloomberg | Note: Axes truncated to exclude COVID pandemic

For the sake of argument, let's say the labour market is as good as the establishment survey would suggest. There's still plenty of reason to expect that the jobs growth will decelerate meaningfully (or turn outright negative) ahead. Chiefly, productivity was in freefall in the first half of the year. In other words, companies are producing *less* with *more* labour. Companies are profit maximizing entities and negative marginal returns on labour aren't sustainable.

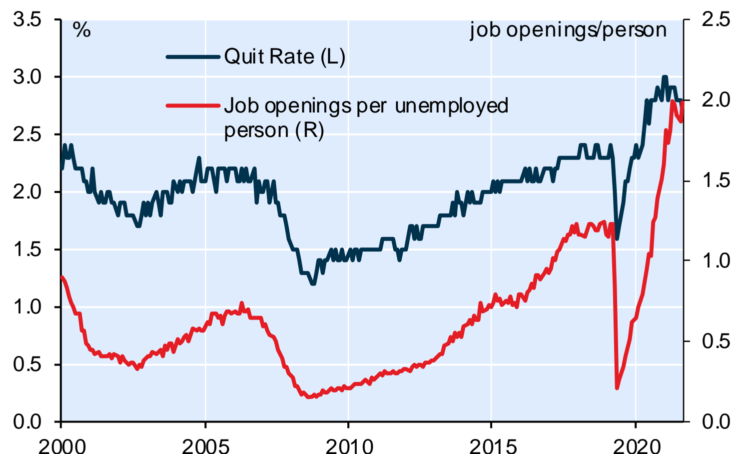
Chart 8: Biggest drop in productivity in at least 75 years
Labour productivity as a function of nonfarm output and hours worked



Source: NBF, Bloomberg

One piece of evidence that does lend support to the still-strong jobs data is the elevated level of job openings. Despite falling from their earlier peak, there are still nearly 2 job openings for every unemployed person in the U.S. economy. That's still near decade-long highs. The Fed's hope has been that the labour market can avoid significant damage from rapid rate tightening because of the abundance of open positions. There may be some truth to that line of argument, but we'd expect those to continue to fall sharply. And historically, that hasn't been a good sign for nonfarm employment, regardless of the starting point.

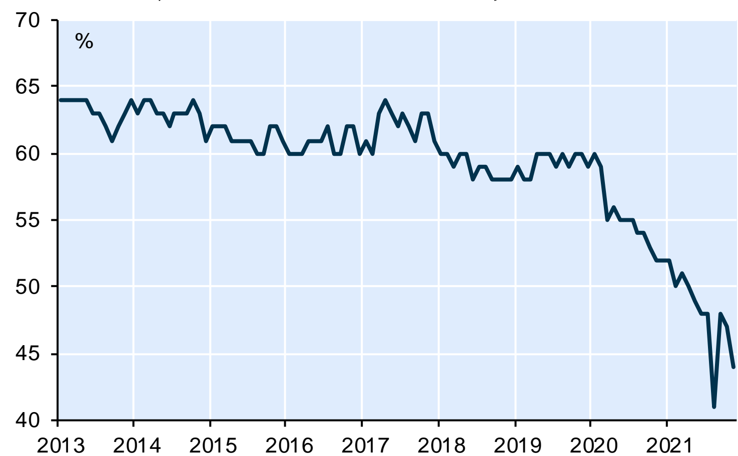
Chart 9: Have job openings peaked?
Job openings per unemployed person vs quit rate, since 2000



Source: NBF, Bloomberg

Finally, it's worth raising that the reliability of the nonfarm survey may not be as strong as it once was. Indeed, response rates in the establishment survey have fallen drastically since the pandemic began. That's also true of the Current Population Survey, but (a) the decline has been less severe and (b) response rates remain at higher levels. One could argue that the firms most likely to lay off workers would be more reluctant to respond to the survey. To be sure, our argument that the labour market is weaker than it appears isn't dependent on this point but it's a notable issue nonetheless.

Chart 10: Should we trust the payroll survey?
Overall unit response rate to establishment survey: 2013 to 2022



Source: NBF, BLS

Overall, we think the U.S. labour market is weaker than the market's preferred indicator might suggest. Discrepancies between the household and establishment surveys have grown historically wide in recent months and, combined with declining survey take-up, have led us to question the reliability of this measure. In reality, the true strength of the jobs market may lie somewhere between indications yielded by the two surveys. But going forward, we expect some convergence. That's likely to be at a much lower level than the July jobs print and lower than the still-solid ~380k run rate in the three months before that. While there is still demonstrable tightness, as evident by an extremely low unemployment rate (which is admittedly skewed by the tepid participation rate), we think we're close to a significant deterioration and a rise in the unemployment rate. Evidence of this could come as soon as this week when the employment situation for August is published. We expect a deceleration in the pace of job creation with a +75k print as our baseline forecast.

Should this hiring deceleration materialize and should that lead to an easing in wage growth, there are major implications for the Fed's rate hiking cycle. While the central bank appears intent to raise rates close to or even above 4% over coming months, we think the ultra-hawkish rhetoric could change relatively quickly. While that might not prevent hikes in September or November, it would lend itself to a slower pace of tightening and might just end up in a terminal rate below market/Fed expectations. We do concede that the path to achieving this outcome is narrowing quickly and is unlikely to materialize without this rapid onset of weakness, but we have some conviction that this weakness is in the pipeline.

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