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Asking the Hard Questions: An Update from Stonebridge's Chief Economist

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Why is the labor market so strong? Why are consumers not more confident about it?

Employment data reported by the Bureau of Labor Statistics continues to reflect a very strong labor market, despite the aggressive interest rate hikes by the Federal Reserve over the last year. In particular, rather than moving higher, the unemployment rate trended lower in 2022, ending the year at a level of 3.5%, which equals its lowest level of the past 53 years. Furthermore, nonfarm payroll employment grew at a rate above its historical average.

Labor demand tends to be far more sensitive to economic conditions than labor supply. As such, the demand for labor typically drives the unemployment rate up or down, especially since the supply of labor is largely based on demographics, which tend to change very slowly and are more predictable than demand. Labor demand is best illustrated by the change in nonfarm payroll jobs, which has averaged a whopping 726 thousand gain per month during the economic expansion since April 2020, exceeding the historical average monthly gain of 220 thousand over the prior 70 years. However, the stellar gains in payroll jobs in recent years reflects the reopening of the U.S. economy following the 20.5 million jobs lost in April 2020 alone owing to the business closures in an attempt to slow the spread of COVID (the pandemic). By August 2022, the economy had recovered all of the jobs lost during the brief but devastating 2020 recession.

The timing of the recovery in payroll jobs is not unusual; normally, it takes years to recover the jobs lost during a recession. The unusual aspect of this recovery was the speed at which the unemployment rate fell. Generally, it takes much longer for the unemployment rate to recover than it does payroll jobs. The reason is that the labor market not only has to absorb the displaced workers from the recession, but it must also absorb the new entrants into the labor force since the recession occurred.

A key reason for why the unemployment rate fell so quickly this time was that the number of new entrants into the labor force roughly offset the surge in retirees leaving the labor force. Interestingly, the total labor force essentially was unchanged over the three years ending in December 2022. The last time this occurred was during an economic expansion in the 1950s, when the unemployment rate bottomed at an extremely low level of 2.5%. The labor force was relatively flat in the 1950s due to the impact of World War II and the Korean War on the labor market; the U.S. population grew but it was mostly the arrival of the baby boomers, who were not yet old enough to be included in the labor force. As one of the first boomers, I didn't join the labor force until I took a summer job at age 16 in 1962, at least officially, suggesting the boomers did not start entering the labor force until then. Now they are leaving the labor force by retiring.

Using history as a guide, another aspect of a tight labor market is that consumer sentiment typically would trend sharply higher as the unemployment rate falls and nonfarm payroll jobs surge. For example, the Michigan consumer sentiment index, which fell to 55.3 during the financial crisis of 2008-09, rose steadily during the economic expansion that followed.

Not this time. Prior to the pandemic in February 2020, the Michigan sentiment index hit 100, slipped some in March, before plunging to 71.2 in April 2020. Although it recovered some over the following year, it plunged again during the second half of 2021 and through the first half of 2022. In December 2022, the index was 56.8. Such a downward trend in consumer sentiment during an economic expansion is unusual and suggests that it reflects something other than the labor market. In that regard, the last time the sentiment index trended sharply downward during an expansion was in the 1970s, which was also the last time consumer price inflation was an issue.

What is more important, the unemployment rate or the change in payroll jobs?

Both the unemployment rate and the payroll jobs data reported by the Bureau of Labor Statistics (BLS) provide important, but somewhat different, information about labor market conditions. The BLS collects the data by conducting two different surveys: the household survey and the establishment survey.

The household survey interviews households to gather information used to calculate the unemployment rate. In this survey, individuals are only counted once—either employed or unemployed and why. In contrast, the establishment survey collects payroll data from businesses. In this survey, employees working at more than one job appear on more than one payroll and are therefore counted for each job. For example, if an individual holds a full-time job, as well as a part-time job, they would be counted twice in the payroll data. Moreover, the establishment data provide various important features of payroll employment other than the number of jobs, including hours worked and average hourly wage. All the information provided by the establishment survey is also available by industry.

As mentioned earlier, the change in payroll jobs reported in the establishment survey reflects the demand for labor, while the unemployment rate provides a clue about the supply of labor. Financial market participants tend to consider the change in payroll jobs more important than the unemployment rate, whereas the Federal Reserve seems to be focused more on the unemployment rate than nonfarm payroll jobs. The implication is that if the economy is operating at full employment, which is defined as the unemployment rate at which most of the unemployed individuals are so-called frictionally unemployed—unemployed more by choice than by circumstance.

The 3.5% unemployment rate in December is well within the range of full employment. In this case, the number of new payroll jobs this year will be constrained by the number of new entrants into the labor force. Over the last year, the U.S. population of individuals aged 16 years and over had increased an average of 225 thousand a month. Of course, not everyone aged 16 years and over will be looking for a job. Indeed, assuming that the labor force participation rate is 63% (I actually think it will be lower), the labor force will rise an average of about 140 thousand a month. The implication is that the economy will remain at full employment as long as the economy can generate at least that many new jobs on average.

One factor that has and will likely continue to have an impact on labor force participation is the aging of the work force. For example, in April 2020, the civilian unemployment rate spiked to 14.7%. Some of those who lost their jobs that month were boomers who were eligible to retire. Many did and dropped out of the labor force by doing so. Others filed for the unusually generous unemployment benefits, which meant they were still considered part of the labor force. However, when they were called back to work, many decided to retire instead, dropping out of the labor force as well. As a result, the labor force participation rate for the cohort aged 65 and over dropped sharply early in the pandemic and has remained near the lower level ever since.

Indeed, it may take years before the labor force participation rate for older workers returns to its pre-pandemic level. The aging of the work force and the surge in retirees in recent years has had a dramatic impact on labor force growth. This is illustrated by the population data by age groups. For example, from February 2020 to December 2022, the number of people aged 16 years or more increased by 5.2 million – an annual rate of 0.7%. However, the bulk (nearly two-thirds) of the gain was in the age group 55 years and older, who are less likely to be employed or looking for employment than the younger cohorts. That said, more consumer price inflation may force older workers to delay retirement and stay in their jobs longer than in the recent past. This in turn will cause the participation rate for those people 65 years and older to increase, which most likely will boost the overall labor force participation rate a bit.

What is the outlook for employment for 2023?

Clearly, the demand for labor in 2023 will depend heavily on how the overall economy performs. At the moment, real output is expected to grow in the first half, albeit at a relatively slow pace, before rolling over into negative territory in the second half. As a result, the demand for labor is likely to be very mixed in 2023. Through the first half of the year, payroll jobs are expected to register monthly gains in line with labor force growth, which are estimated at about 150 thousand a month. In the second half of the year, job growth is expected at a pace below that of labor force growth, owing to the strong likelihood of a recession this year. Obviously, the more severely the economy slows in 2023, the more punishing the impact on jobs.

Since August 2022, when total nonfarm payroll jobs finally recovered the 20.5 million jobs lost during the last recession, the monthly gain in payroll jobs has averaged about 250 thousand. Although still a solid average gain, it is only slightly above its historical average. The conclusion is that the reopening of the U.S. economy during the pandemic was a huge factor in the oversized monthly gains in payroll jobs. However, now that all of the jobs lost in the pandemic-induced recession of 2020 have been recovered, the reopening of the economy will be less of a factor in 2023. Nevertheless, the aging of the population will complicate interpreting the payroll jobs data, as well as the unemployment rate.

According to the December forecast, the economy is expected to plunge into a recession sometime later this year. As noted numerous times, the economy is generally shocked into a recession, not orchestrated into one. That said, even in the absence of such a major shock, U.S. economic growth will still be sluggish, as reversals plague various sectors at different times—often referred to as "rolling recessions." The housing, tech and financial sectors are already facing reversals. I suspect that as monetary policy becomes more restrictive, manufacturing, especially durable goods manufacturing, likely will suffer as well.

I still expect the overall economy to be shocked into a recession but I do not know what that shock will be, nor when it might occur. If we knew, it would not be shocking. As such, timing the recession remains difficult. The consensus seems to be that the U.S. economy will slip into a mild recession early this year, easing inflation pressures and allowing the Fed to reverse course by lowering interest rates. I doubt it will be that easy. When it does occur, I expect the recession to be something closer to a typical recession, which would be more severe than the consensus forecast and approximately 9-12 months in duration.

Even though inflation has moderated considerably in recent months, should the Fed be worried about higher wages triggering another surge in inflation?

Because various inflation measures showed considerable improvement in the final few months of last year, it begs the question of whether the Fed will need to raise interest rates much further, if at all. For the most part, economists are still relatively hawkish about monetary policy, expecting the Fed to follow through on their commitment to raise rates a bit more in the near term. At the same time, most economists expect higher interest rates to eventually derail consumer spending, loosen labor market conditions and ease inflation even further. Clearly, the more interest sensitive sectors of the economy will suffer this year. In fact, there is some evidence that some of these sectors are already under pressure. Nevertheless, the suffering so far is not broad enough or deep enough to suggest a recession.

The key to whether the U.S. economy falls into recession depends on if the Fed slows things down enough to give the economy enough time to correct the supply-chain disruptions and adjust operations to accommodate fewer workers without raising interest rates to levels that would expose the economy to serious risk. For the most part, many of the supply disruptions have been corrected but the adjustment by businesses to the labor situation may take longer. It takes time to adjust operations, either through investment or innovation, to provide workers with the means to be more productive, which is exactly what has to happen if inflation is to improve without a recession.

Many people scoff at the suggestion that labor needs to be more productive because they generally associate productivity improvement with employees being asked to work harder. Although working harder may boost total output, it is a short-term solution that generally translates into more hours worked at the same pay. Pressuring employees to work harder only alienates them and will most likely hamper productivity. Productivity gains, which is real output produced per hour worked, generally involves working smarter, not harder. Quite often, productivity improvement requires training, capital investment or innovation to allow workers to do more per hour. Furthermore, productivity improvement is essential for higher living standards. A gain in real wages can only be sustained if it is the result of being more productive. If wages go up because of higher prices, it tends to lead to more price hikes, resulting in lower real wages or at best, no change in real wages. If a wage gain is due to increased productivity, businesses can pay a higher wage without raising prices, while at the same time report improved profits.

This last point is why economists tend to focus on unit labor costs, defined as labor costs per hour divided by real output per hour, when assessing corporate profit growth. Lower unit labor costs improve the outlook for profits, whereas higher unit labor costs depress the outlook for profits. In the first half of 2022, the percent change in unit labor costs from a year ago surged before slowing sharply in the third quarter and likely slowed further in the fourth quarter. At the same time, the percent change in corporate profits after taxes adjusted for inventory and depreciation accounting differences slowed markedly over the first three quarters of 2022 and is expected to decline in the fourth quarter from a year earlier.

The outlook for unit labor costs in 2023 is for the percent change from a year ago to remain elevated, as wages are sticky upward while real output per hour (productivity) struggles to improve in the wake of a recession. Based on where productivity is at the moment, the unemployment rate is likely on the brink of moving higher. The anecdotal evidence suggests that jobs are starting to decline. How high the unemployment rate will go depends on whether the U.S. economy goes into recession this year and how severe it will be. Although a recession seems to be the more likely outcome, it still is not a sure thing. One thing worth mentioning is that even if an outright recession is avoided in 2023, real gross domestic product (GDP) growth still is likely to be "slow motion" by historical standards.

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