Economics

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No love of labor: Why the US labor market needs some preventative medicine

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The American labor market looked like it reached a breaking point, and then it didn't. The September jobs report and the recent revisions to income and the saving rate have provided plenty of ammunition to the no landing camp. But don't get too caught up in one report. The economy does not move in a straight line.

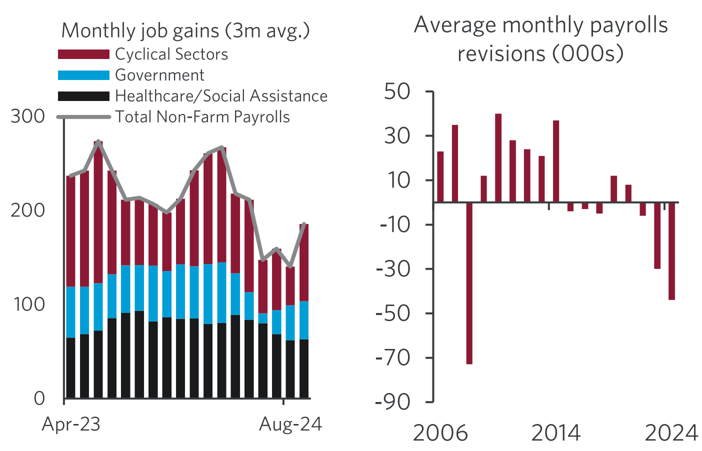
Yes, GDP figures look robust, but that's not where the real tale is. The real answers lie in the job market, where there are clear signs of softening. Payrolls are being propped up by government and healthcare hiring, while employment growth in the household survey is nowhere to be found. The job market has gone from overheated to healthy, but the risk of material slack opening up might be higher than you think. The Fed is well aware of this risk, and will dole out the right amount of medicine to prevent the job market from completely breaking.

Love at first sight can break your heart

That September jobs report and the benchmark GDP revisions broke a lot of hearts. The post-pandemic GDP recovery is now stronger than we thought, and third quarter nowcasts are telling us that GDP momentum is solid. But the recent trend of job growth and the pattern of revisions has still been clearly downward (Chart 1). In fact, the upward revisions in the September report stands out as an outlier. No less than 80% of the monthly revisions since the beginning of 2023 were downward revisions. We think that that trend will be maintained due to continued undersampling of small businesses in the first round of the payroll survey.

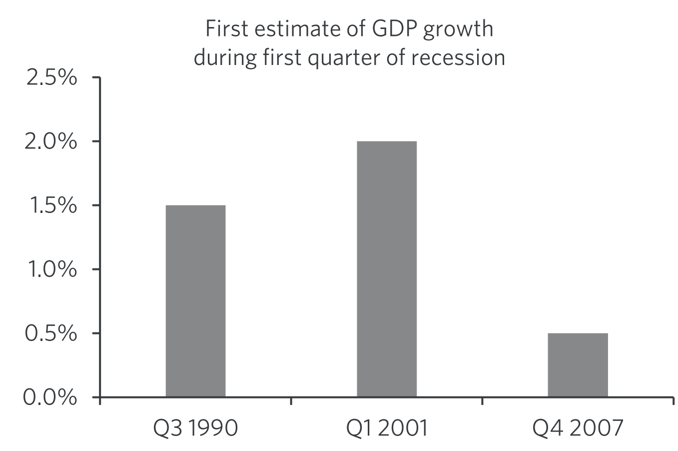
In a tug of war between the rosy GDP picture and a cooling job market, the main focus should currently be on the latter. History tells us that as we approach an economic turning point, the job market usually tells the true story. Take a look at Chart 2. The early 90s recession started officially in the 3rd quarter of 1990. Back then the official first estimate of GDP growth was 1.5% — granted, well below potential growth at the time, but not exactly recessionary territory. Ditto for the early 2000s recession and the GFC. This means that in real time that's the information the Fed was exposed to in determining monetary policy. Only after significant downward revisions did those GDP figures enter negative territory.

Chart 1: Job growth has slowed materially since last year (left), and payrolls have been consistently revised down for two years (right)



Note: Revisions are the difference between third and first est. Source: BLS, CIBC

Chart 2: Advance releases of GDP have missed past recessions



Source: BEA, CIBC

That clearly was not the case when you zoom in on payroll employment during those turning points (Chart 3). Job growth was already in negative territory in the first quarter of the 1990s recession and the financial crisis, while falling dramatically in the early stages of the dotcom bust.

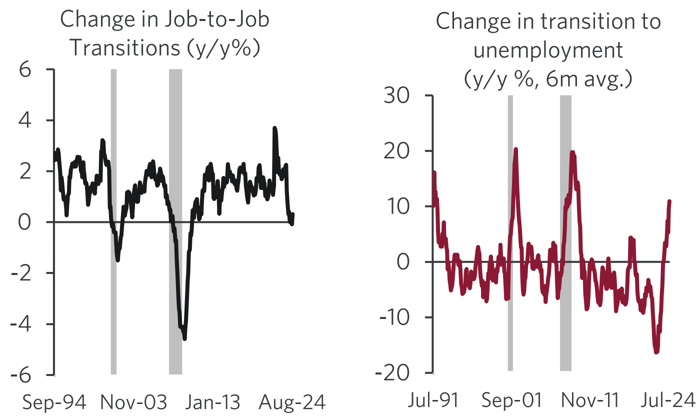
We're not saying that the US is headed for a recession in GDP terms— solid asset income and retired baby boomers living the good life are creating a wedge between a softening job market and consumption. But still, over 60% of national income comes from labor, and so, some slowdown in the economy seems inevitable with employment gains running more than 100K below where they were at the start of 2023.

And there are a number of leading indicators pointing to the risk of more labor pain ahead. At any point in time the unemployment rate reflects two forces: the probability of becoming unemployed and the probability of staying unemployed. Both are currently on the rise. As illustrated in Chart 4 (left), job hopping has completely stalled out and the only time it was so low was in recessions. Chart 4 (right) looks at the change in flow from employment to unemployment — and that figure is now the highest it has been in a non-recessionary period. Futuring hiring intentions of small businesses, the cyclical engine of labor market, are plummeting (Chart 5).

But why?

The labor market has clearly slowed, but the question is why, especially considering that GDP growth has remained stellar. There are two main explanations. The first, and how to square the job market with GDP, is businesses have prioritized and invested in productivity to the point where they just don't need to add as much labor at this stage of the expansion. The second reason, is that increased reliance on capital was, in part, due to how expensive labor has become post-pandemic. Labor costs have continued to rise and are threatening profit margins.

Chart 4: Job-to-job transitions have stalled out (left) and the unemployed are not finding work (right)



Note: COVID period, 2020-June 2022, excluded. Source: BLS, CIBC

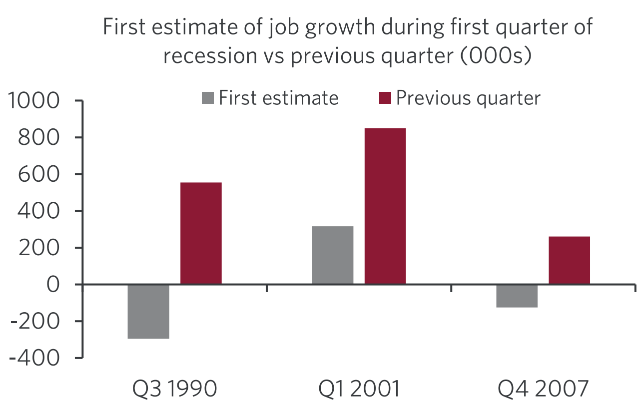
Interestingly, interest rates have played a lesser role in squeezing businesses and weighing on hiring, but that's mainly because firms were effective borrowing at rock bottom rates in 2020 and 2021, much like households. They have also shielded themselves by holding off on borrowing as well, with commercial credit growth at multi-decade lows.

Creative Destruction

The role of productivity in cooling the labor market is not hard to spot. Most of the increase in unemployment over the past year, has come in sectors that have seen the largest acceleration in productivity (Chart 6). This increase in productivity has been broad-based, including in the country's largest sectors: Finance (21% of GDP), Professional and Business Services (13%), Manufacturing (10%) and Education and Health (9%).

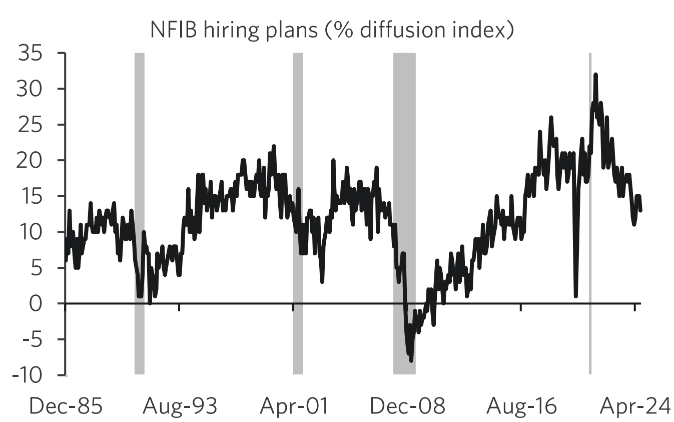
Part of that improvement in productivity likely reflects sustained investments in software and R&D over the past four

Chart 3: The job market was quicker to reflect recessionary conditions



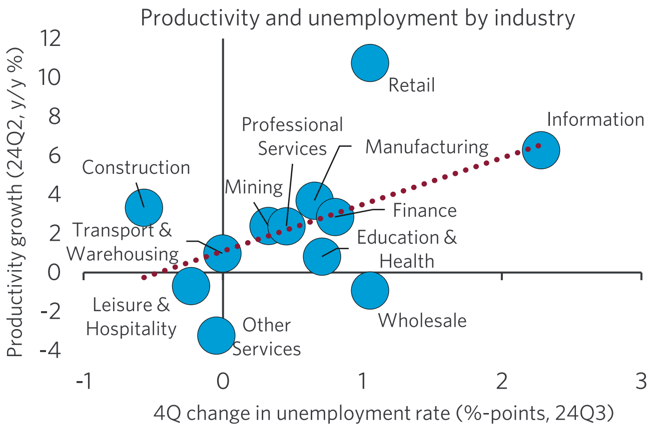
Source: BLS, CIBC

Chart 5: Small business hiring intentions are coming down fast



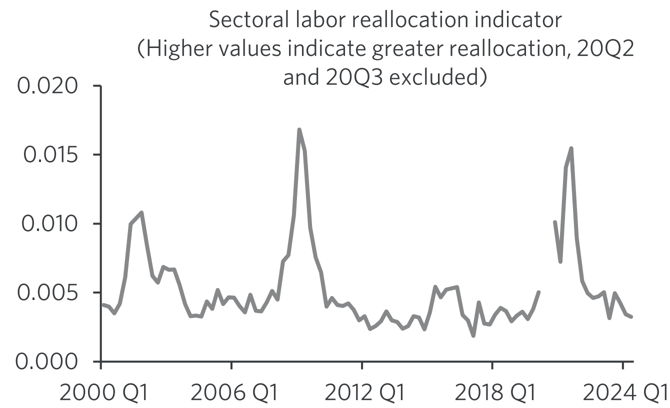
Source: NFIB, CIBC

Chart 6: Rising joblessness has come in more productive sectors



Source: BEA, BLS, CIBC calculations

Chart 8: The American labor market has seen a large and prolonged reallocation across sectors



Note: 2020Q2 and 2020Q3 are excluded, these values were 0.1 and 0.05 respectively. Source: Methodology based on Lilen (1982), CIBC calculations

years, the largest portion of Intellectual Property Products (IPP) investment (Chart 7).

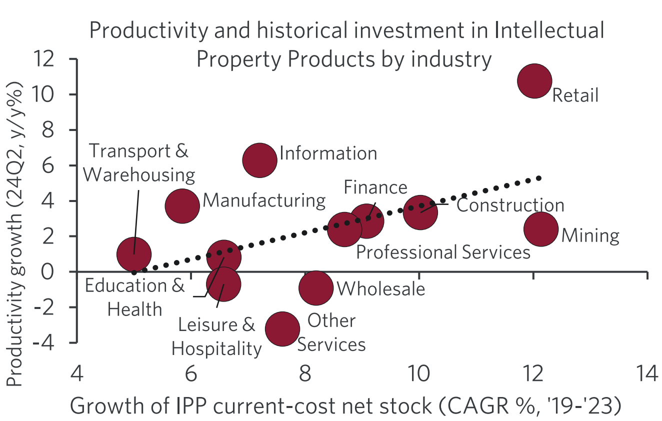
The other, and potentially more important part of the picture, is how labor has been reconfigured post-pandemic. Higher growth and productivity is typically associated with stronger labor market performance, as higher returns mean adding labor helps to further scale up.

But the pandemic saw the American labor market experiencing substantial upheaval, with far more limited efforts to preserve attachment of workers and firms than in Canada and the Euro Zone. The result was a large and prolonged reallocation of labor across sectors that is now finally complete (Chart 8). In that process — part of which was the so-called "Great Resignation" — workers flowed to sectors of the economy that were better matches and more productive sectors doubled down on a less expansive but more skilled workforce, paired with a better technology.

You can see some of the aftermath of this reconfiguration in the composition of job openings, which show some creative destruction (Chart 9). Private service firms have less demand for labor as compared to the public sector and public-related sectors like healthcare and education compared to pre-pandemic. Retailers, a historically labor intensive sector, has seen its share of overall job openings plummet over the post-pandemic period. Improved automated checkout machines and apps are replacing cashiers, as are online communication tools reducing business travel costs, and AI is starting to replace some jobs with routine but moderately skilled tasks, like copywriting.

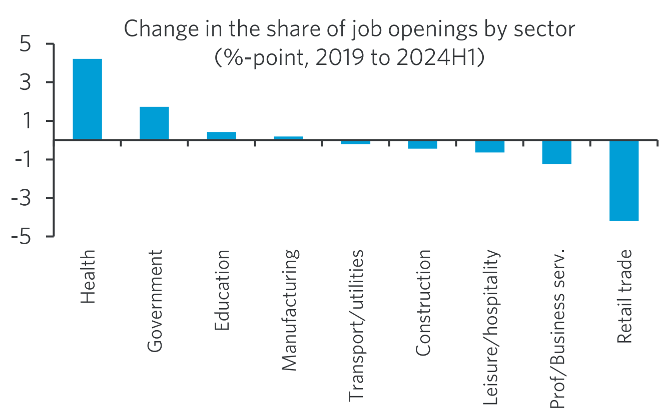
Within sectors, the type of worker that businesses want has changed too. Employment shares of managers and skill-professionals have increased at the expense of administrators and point-of-contact service personnel (Chart 10). Some part of this shift reflects an ageing labor force that itself is higher skilled, but the size and speed of the shift likely can't fully be explained that alone.

Chart 7: Stronger productivity is also associated with higher investment in software and R&D



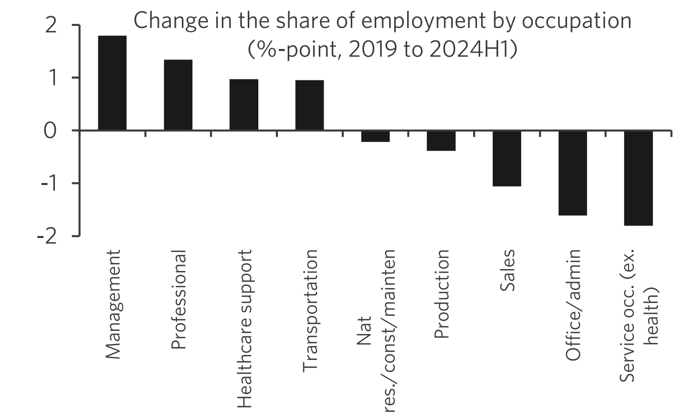
Source: BEA, CIBC calculations

Chart 9: Labor demand is titled towards the public rather than private sector now



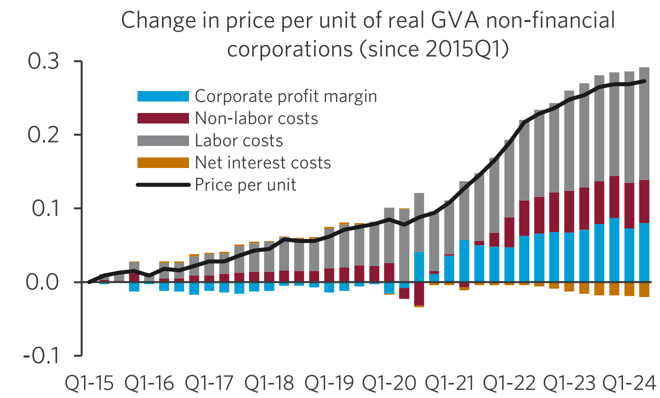
Source: BLS, CIBC calculations

Chart 10: Employers want more high-skilled workers to pair with investments in technology



Source: BLS, CIBC calculations

Chart 12: Profit margins have risen, but so have other costs



Source: BEA, CIBC calculations

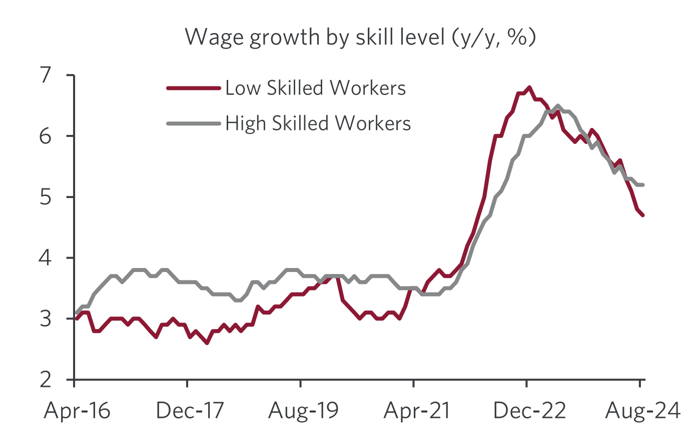
Good things don't come cheap

But creative destruction, has its limits and costs. The wage growth of higher skilled workers is coming down more slowly than other workers (Chart 11) and risks pushing up overall wage growth above productivity growth, as and if more of those workers are added. At some point too, business are cognizant that the cost of materials and inputs will have to pick up as well.

That leaves them two options: either pass on costs to consumers in the form of higher inflation, or try to do without as much labor and preserve margins. The steady pace of consumer inflation and the gradual rise of joblessness over the past year is making it clear they are choosing the latter.

And that is for good reason. Corporate profit margins have increased substantially post-pandemic, but that is after a half decade of being flat (Chart 12). Most of the increase in profit margins occurred around the onset of the pandemic, and of course, both labor and non-labor costs have also increased substantially over past four years.

Chart 11: But high-skilled workers are expensive



Source: Atlanta Federal Reserve Bank

Also waiting in the wings are higher interest expenses. About 20% of the increase in corporate margins is due to firms slowing commercial borrowing due to higher rates. As borrowing normalizes, likely at somewhat higher interest rates, that too could eat up corporate margins.

So businesses don't have a lot of room to maneuver other than to try control labor costs. That will mostly likely mean more pain ahead, with the same ingredients we have seen over the past few months. Hiring will remain anemic but only limited firing, as companies are fully staffed with the right mix of workers and capital and losing skilled workers could hurt the bottom line more than help it.

Not easy for the Fed

The path forward for the Fed is not easy. Post-pandemic forces, rather than monetary policy, are creating a unique economic environment of solid growth but a cooling jobs market. And the risk of a false signal from real-time GDP, and GDP slowing on account of slowing labor income, means the Fed has to be more attentive to the job market for a better read on the economy.

The Fed's only tool to cure the ills of its labor mandate is the interest rate hammer, and that only works with a lag and with less power than it once did. But they have no choice, and certainly won't tolerate a material rise in unemployment, independent of the causes. We expect Powell to bring the Fed steadily back to the neutral rate of 3.5% by the middle of the year, giving the US labor market the preventative medicine that it needs.

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