DWS

Marketing Material

IS THE U.S. LABOR MARKET TURNING?

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IN A NUTSHELL

_ Labor-market data indicates an ongoing moderation.
_ The Fed is expected to remain on hold for the time being – muted wage growth tames inflation and growth is still expected to be above potential.

Labor-market data for December disappointed. So what, one might say, it is just payback after a very strong November. Do not judge too fast, would be our take. While November was indeed exceptionally strong, there are signs in the data which might signal the beginning of a transition toward a more moderate labor-market regime.

The U.S. Bureau of Labor Statistics (BLS) estimated that 145,000 new jobs (non-farm payroll employment) have been created in December 2019 – a disappointing number compared to consensus expectations and down from 256,000 in November. Private payrolls added 136,000 (after 243,000) and this time both main sectors showed lower hiring: goods producing decreased by 1,000 and service providing increased by 140,000 from 191,000 in November – significantly below its three month moving average of 175,000.

These numbers are, however, estimates. Besides, the usual messy task of seasonal adjustments, there are others as well. For instance, the BLS must make assumptions about firms going out of business and those being established within any given month. The BLS therefore uses the so called "Birth/Death Model" to deal with this statistical challenge.[1] Historically, closures of existing firms and launches of new businesses tend to roughly offset each other, on average. It is reflected in the data by ignoring those companies that did not answer the survey (as they probably shut the doors) and assuming that the same amount of new companies (which cannot reply, yet) have been created to replace them.

After this first step, some complicated time-series statistic is applied to fine-tune the adjustment, reflecting, for example, cyclical effects. The following chart illustrates the impact such modifications can have: in an upturn, such as the one since 2010, it is safe to assume that openings should outweigh closures; vice versa, however, closures should tend to outnumber newly created companies in a downturn.

Some bearish market observers attributed the strong increase in retail and construction hiring in December to the idea that the "Birth/Death Model" fails to correctly account for enough closures, thereby overstating hiring. We, on the other hand, humbly acknowledge that the chart most likely tells a different story. It already indicates a moderation in economic activity. Perhaps the model's mathematics started to scale down the upward compensation which a booming economy would require. This is in line with our view of fading economic momentum. The shortcomings of these reports become eminent in the so called "Current Employment Statistics (CES)" benchmark revision for 2018 and early 2019 when past estimates are cross-checked to reality. The BLS revision announcement already suggests that non-farm payrolls might be overstated by roughly 500,000 in the period from March 2018 to March 2019.[2]

[1] https://www.bls.gov/web/empsit/cestn.htm/section6c
[2] https://www.bls.gov/web/empsit/cesprelbmk.htm

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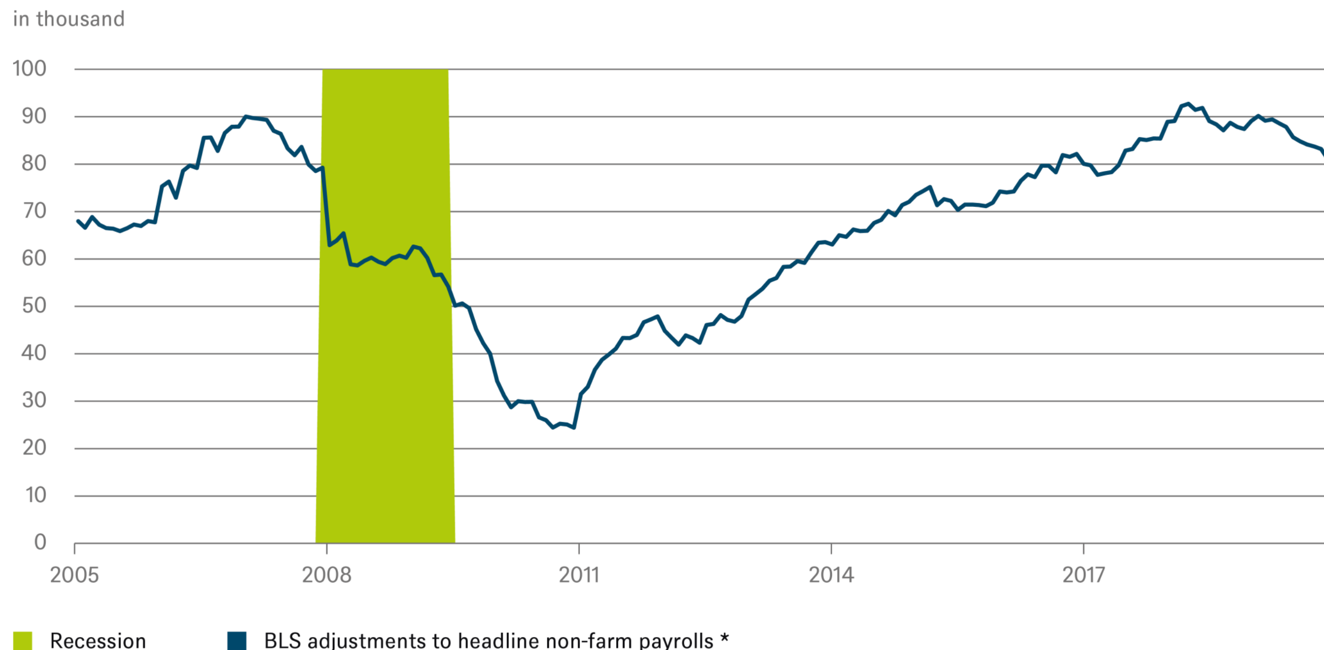
BLS ADJUSTMENTS INDICATE LESS MOMENTUM IN NON-FARM PAYROLLS



* "Birth/Death" adjustment; non-seasonally adjusted, 12-month moving average
Sources: National Bureau of Economic Research, Bureau of Labor Statistics, Haver Analytics, DWS Investment GmbH as of 1/14/20

Another, also not so comfortable trend is the decline of wage growth. Average hourly earnings trended down to 2.9% year-on-year from a peak around the end of 2018 at 3.4% year-on-year. Simultaneously, there was a downward trend in weekly hours worked. Given all this, it is only reasonable to doubt whether personal income growth and of course consumption can hold up looking ahead. And indeed recent trends in retail sales are not so comforting. After a strong rebound in the second and third quarter of 2019, caused by the end of the government shutdown, retail sales growth leveled-off considerably below the income tax cut driven by the spending spree of 2018. At least the shopping season seemed to go well, December retail sales have been stronger at 0.3% month-on-month after a weak shopping kickoff in November (-0.1% month-on-month).

On the supply-side, the latest sentiment figures indicate a further divergence between the manufacturing and the service sector. The ISM manufacturing (Purchasing Manager's Index (PMI) for December disappointed significantly to the downside at 47.2 as production dropped to 43.2 from 49. New orders declined while new export orders remained stable – a sign that weakness was domestic this time. In sharp contrast, the PMI for the service sector surprised to the upside by increasing to 55.0 from 53.9. Despite the sound headline number, the details have been mixed. The headline was mainly driven by business activity (57.2 from 51.6) while new orders declined and the important employment component stagnated. As of now, we still do not see major spillovers from the very weak manufacturing sector into services. Looking ahead, we expect manufacturing sentiment to improve somewhat given the signing of the phase-one trade deal with China. However, we still flag that the current form of the deal is rather a preservation of the status -quo and does not resolve the trade war entirely.

Our take on the recent developments would be that the U.S. economy remains well positioned from a cyclical perspective. We already expected labor markets, consumption and ultimately growth to moderate gradually through 2020. For the time being, the U.S. Federal Reserve (Fed) might not be derailed by the recent developments. Moderate wage growth should tame inflation and growth is still expected to be well above potential. We expect policy makers to keep monetary policy on hold through 2020. However challenges to this outlook remain. An unresolved trade war, reemerged geopolitical tensions in the Middle East and 2020 as an election year promise to keep us busy. Happy New Year.

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OVERVIEW: KEY ECONOMIC INDICATORS

	2019				2020				2021	
	Q1	Q2	Q3	Q4F**	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F
GDP (% qoq, annualized)	3.1	2.0	2.0	1.6	1.6	1.6	1.4	1.6	1.6	1.6
Core inflation (% yoy)*	1.6	1.6	1.7	1.8	1.9	1.9	1.9	1.9	1.7	1.9
Headline inflation (% yoy)*	1.4	1.4	1.4	1.6	1.6	1.4	1.3	1.4	1.6	1.8
Unemployment rate (%)	3.9	3.6	3.6	3.5	3.5	3.6	3.7	3.7	3.8	3.8
Fiscal balance (% of GDP)	-4.1	-4.3	-4.6	-4.6	-4.8	-4.6	-4.8	-4.8	-4.8	-4.8
Federal funds rate (%)	2.25-2.50	2.25-2.50	1.75-2.00	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75

* PCE Price Index
** Forecast

GLOSSARY

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The U.S. Bureau of Labor Statistics is part of the U.S. Department of Labor and is responsible for measuring labor-market activity, working conditions and price changes in the economy.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

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