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Five Metrics We Are Watching in the Labor Market

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Overview

Unemployment in the US is hovering around historic lows at 3.5%.[1] For much of 2021 and all of 2022, the number of job openings exceeded the number of unemployed workers who might be able to fill these positions. Wages and salaries rose in the US as the economy reopened from pandemic lockdowns. For most of the past year, most indicators have pointed to a healthy labor market.

But the strong labor market may be making the Federal Reserve's inflation fight more difficult. Higher interest rates alone could be insufficient to beat inflation. Consumer demand for goods and services most likely must fall for inflation to subside. Said another way, without a weaker jobs market and smaller wage gains, inflation may not return to the Fed's average inflation target of 2%. The last time we witnessed inflation this high in the US was the early 1980s when the Consumer Price Index (CPI) rose to 14%. Soon after, unemployment rose to over 10% even as inflation started to fall (see Figure 1). The threat of the wage spiral - where prices and wages rise rapidly together - can drive inflation higher even as economic growth sputters, a phenomenon the US experienced in the 1970s.[2] In 2023 the US economy is far from these extremes of the Volker era with unemployment at only 3.5% and headline inflation falling from its peak of 9.1% last June to 5.0%.[3]

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[1] Source: Bureau of Labor Statistics (BLS) as of April 7, 2023. April report shows February 2023 data.

[2] Source: Federal Reserve FOMC press conference transcript February 2023.
For additional discussion on stagflation please see Meketa's white paper "Stagflation."
Persistent and surprise inflation can impact portfolio returns. For additional discussion on inflation and its impact on asset performance see Meketa's white paper "Is Inflation Coming and Should We Care?"

[3] Source: FRED and BLS as of April 12, 2023. April report shows February 2023 data.

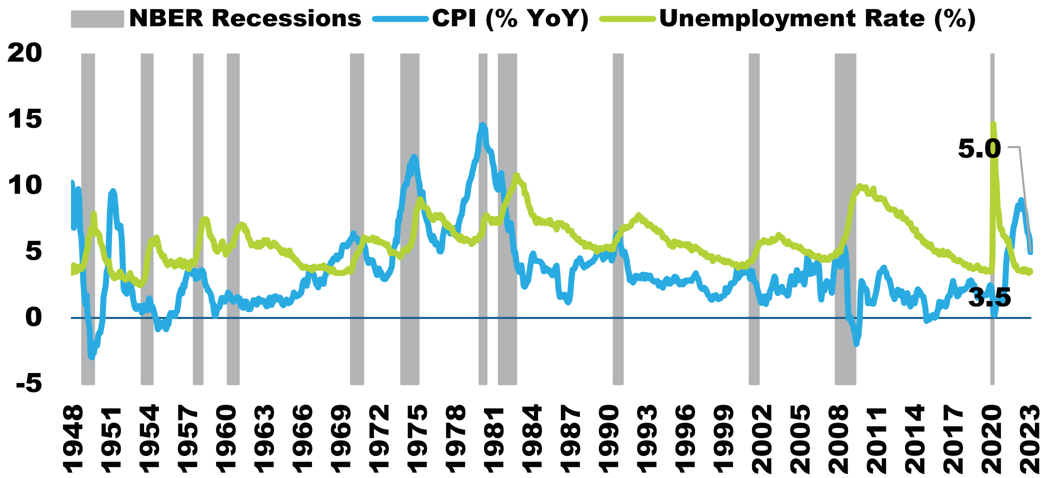

FIGURE 1

US Unemployment, CPI, and Recessions (1948 - 2023)

Source: FRED as of April 12, 2023.

The Federal Open Market Committee's (FOMC) March economic projections forecast that the US unemployment rate will rise from 3.5% to 4.5% by the end of the year.[4] The FOMC estimates that the unemployment rate will rise further to 4.6% in 2024 and remain at that level through 2025 when Core Personal Consumption Expenditure (PCE) inflation is projected to fall close to target at 2.1%.[5]

In this research note, we take a closer look at five key labor characteristics that could provide some evidence that the labor market is weakening, and economic demand is cooling. Typically, an economic recession includes broad-based job losses.[6] We also weigh post-pandemic variables that could keep labor markets stronger for an extended period. The factors we explore include:

Real wage growth | Nominal weekly wages have risen rapidly over the past three years but have not kept pace with inflation. When demand for labor is strong, wage gains are typically more evident.[7]

Unemployment rate and long-term unemployment rate | Both are currently near historic lows.

Labor force participation rate for all workers, women, and those over the age of 55 | Older workers and women have not fully returned to the labor force after the pandemic.

The ratio of job-openings to job-seekers | Prior to the pandemic, the balance between job openings and available workers was similar, but now there are more openings than workers.

Quit, hire, and lay-off rates | Lay-offs remain low, while hires and quits are above their pre-pandemic levels.

Unemployment, inflation, and recession: the Fed's balancing act

Inflation exhibits a strong tendency to rise ahead of recessions. Higher prices and wages often lead to central banks increasing interest rates to cool inflation, but this also puts pressure on the labor market as overall slower economic activity leads to lay-offs. Unemployment data can be an indicator of a coming recession

4 Source: Federal Reserve FOMC economic projections March 2023.

5 Source: Ibid.

6 Source: National Bureau of Economic Research (NBER) "What is a Recession?"

7 Source: NBER "What is a Recession?" The NBER considers non-farm payrolls and PILT "Personal Income Less Transfers" among other labor market indicators to mark the on-set of a business cycle contraction (recession).

and understanding labor market dynamics can offer insights into both the duration and depth of a recession. On average, since 1969, the US unemployment rate has troughed (reflecting a strong labor market) about nine months before a recession begins.[8] As the rate of unemployment rises, the economy may be pushed into recession.

We could enter a recession with a relatively healthy labor market. The National Bureau of Economic Research (NBER) - the official body which declares a recession - does so after the recession has already begun.[9] In the post-WWII era, unemployment has peaked about 15 months on average after the start of a recession.[10] Such retroactive declaration of the start of a recession may not be all that helpful to market participants. However, recent analysis of unemployment and recessions in the US shows that even small changes in the unemployment rate may be used to anticipate a coming recession much like how the inversion of the yield curve may also foreshadow a recession.[11] Once a strong labor market begins to turn, the recession may have begun, with more job losses to follow even after the recession officially ends.[12] But thus far, the US labor market has yet to show signs of weakening even as economic growth has slowed.

The current economic environment in the US is atypical. The impact of the COVID-19 pandemic lockdowns on supply chains, combined with the massive fiscal and monetary response in the US, displaced the typical drivers of the business cycle. Unprecedented government unemployment benefits, rental and student loan repayment forbearance schemes, and other fiscal programs stimulated demand when many businesses were shuttered. The US economy, instead of falling into a prolonged recession as the result of lockdowns, rocketed to very high rates of economic growth, more than double the rate of growth normally expected for the largest economy in the world.

The economic boom that lasted from mid-2020 through 2021 has slowed considerably. Yet, even as growth slowed, surging domestic demand combined with lingering supply chain constraints continued pushing the prices of goods and services sharply higher. In response, the Federal Reserve began raising interest rates in 2022. While inflation has been declining since last summer, it remains well above the Fed's target range. Hence, the Fed's aggressive policy tightening has slowed growth and somewhat lowered inflation, but it has not had a significant impact yet on the labor market.

The Federal Reserve's "dual mandate" is to 1) ensure price stability (i.e., low and stable inflation) and 2) support maximum employment. At this moment, the actions needed to achieve these two objectives seem to be diametrically opposed.

[8] Source: ST. Louis Federal Reserve, "Recession Signals the yield curve vs. unemployment rate troughs," June 2018. Since 1969, on average the yield curve inverted about ten months prior to the start of a recession.

[9] Source: NBER, "What is a Recession."

[10] Source: Cleveland Federal Reserve, T Murat et al. "Forecasting Unemployment in Real Time During the Great Recession: An Elusive Task," November 30, 2015.

[11] Source: Federal Reserve Bank of San Francisco, T. Martens "Recession Prediction on the Clock," December 27, 2022.

[12] Source: Ibid.

Real wage growth

The last time the US saw inflation this high was the 1970s and early 1980s. At that time, as many as one in five workers was part of a labor union where wages were indexed to inflation.[13] Although the US government attempted to limit inflation's impact with price caps and wage indexing, the result was suboptimal. When wages rose along with inflation, consumer spending did not change and fueled inflation pressures further. Price caps resulted in scarcity that was followed by "catch-up" price surges when the caps were lifted.

During the COVID-19 pandemic, many employers had to offer higher wages and more benefits to attract workers. The result was that nominal annual wage growth rose from around 2-3% a year to 4-6% between 2021 and 2022 (see Figure 2). Between January 2020 and March 2023, the average hourly wage rose from $28.43 to $33.18.[14] Average hourly wages grew 4.2% year-on-year after growing at around the same rate between 2021 and 2022.[15] Despite these increases, real wages did not keep up with inflation for most of 2021 and 2022. After inflation-adjusted wages rose in the early part of the pandemic, they fell rapidly as inflation accelerated in 2021.

[13] Source: BLS, "Minimum Wage Report", February 2021. In the late 1970s, over 13% of workers had wages tied to federal minimum wage rules and cost of living adjustments. Today that ratio is less than 2%.

[14] Source: BLS as of April 7, 2023.Refelcts Average Hourly Earnings of All Employees, Total Private.

[15] Source: Ibid.

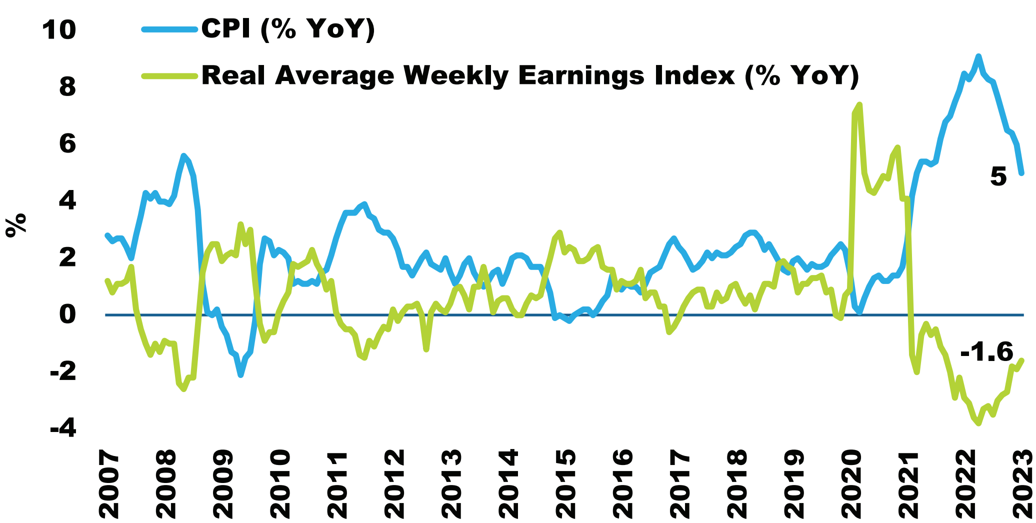

FIGURE 2
CPI & US Real Average Weekly Earnings Index (% YoY)
Source: Bloomberg and BLS as of March 31, 2023.

The labor force participation rate

Pandemic lockdowns disrupted labor markets and some cohorts of workers have not yet returned to work, thereby contributing to labor scarcity. The labor force participation rate measures the percent of the working age population that is employed or actively looking for employment.[16] After a long upward trend that was driven by more women joining the workforce, the participation rate in the US has been slowly declining since the late 1990s (see Figure 3). During the pandemic, 8.2 million workers left the workforce for various reasons, and the participation rate dropped from 63.3% to 60.1% in April of 2020.[17] It has slowly improved since then, but it has not returned to pre-pandemic levels, thus raising questions. For example, if potential workers are interested in finding employment, why has there not been a complete recovery in the participation rate?

[16] Source: US Bureau of Labor Statistics. The labor force includes all people age 16 and older who are classified as either employed or unemployed.

[17] Source: Brookings, K. Abraham et al, "Where are all the missing workers," March 29, 2023.

Perhaps in response to the pandemic, the boomer generation has started to retire, leaving jobs that require years of skill and expertise with too few qualified applicants to fill them. Another trend associated with the pandemic is the so-called Great Resignation. The quit rate - where workers leave a job voluntarily - rose for most of the pandemic. While it has moderated in recent months, it remains well above pre-pandemic levels (see Figure 6). Many workers were laid off or furloughed in the early part of the pandemic. Federal programs funneled income and tax breaks to inactive workers. For many of these potential workers, returning to work has been an uneven process. For example, jobs in some sectors, like leisure and hospitality, are still below pre-pandemic levels.[18]

A reduced interest in lower pay jobs and an interest in flexible work schedules are among the major reasons that have contributed to many not returning to the work force. For workers over the age of 55, the participation rate fell from 40.3% to 38.8%, with retirements explaining about two million exits from the workforce.[19] Demographers expect that the participation rate for Americans over the age of 55 will continue to decline as the baby boomers retire.

Women workers' participation rate also declined during the pandemic. The current rate of 57.1% has only partially recovered to the pre-pandemic level of 57.8%.[20] Pandemic era closures of schools and daycare placed a particular burden on women, causing many to exit the labor force. Various explanations for women's delayed re-entry to the workforce include the high costs of childcare and early retirement.[21]

[18] Source: BLS US Jobs Report, March 7, 2023. Transport and warehousing employment is up 16.1% since February 2020 while Leisure and Hospitality are down 2.4% for the same period. See also Financial Times as of March 7, 2023.

[19] Source: Brookings, K. Abraham et al, "Where are all the missing workers," March 29, 2023.

[20] Source: FRED as of December 2022. Women's participation rate peaked in the late 1990s around 60%. Workers over the age of 55's participation rate rose in the 1990s and early 2000s peaking around 40%. See also, BLS as of April 7, 2023. April report shows February 2023 data.

[21] Source: BLS as of April 7, 2023. April report shows February 2023 data.

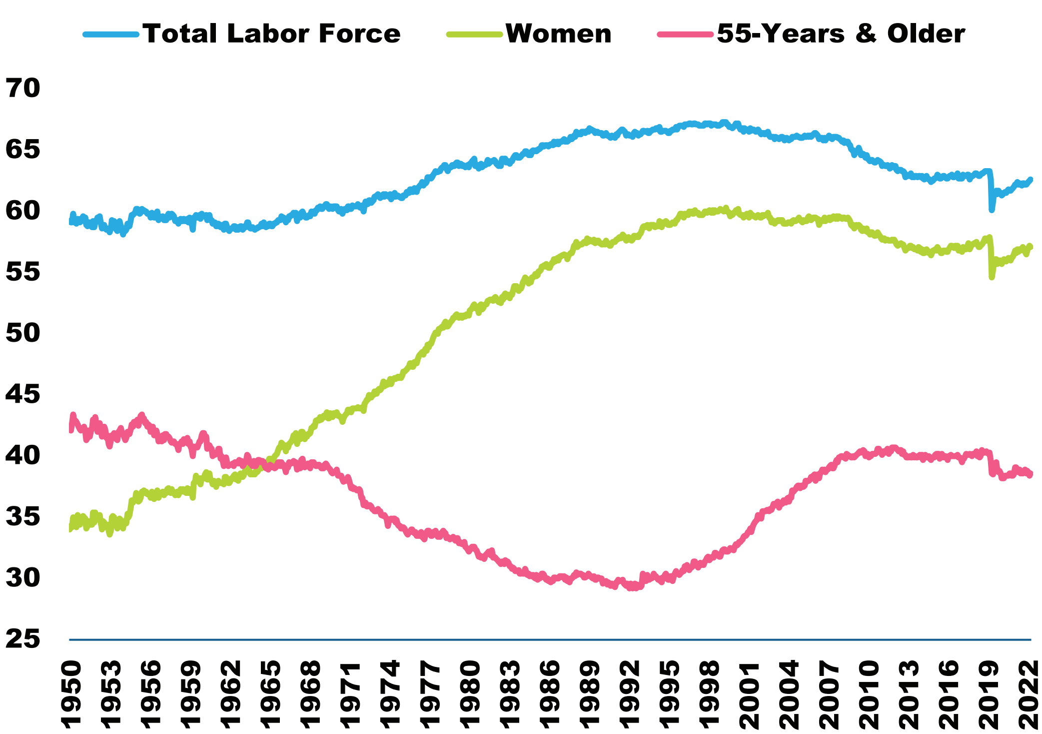

FIGURE 3

US Labor Force Participant Rates (% of Total)

Source: FRED as of April 7, 2023. April report shows February 2023 data.

Long-term unemployment

The long-term unemployment metric tracks the number of people seeking employment that have been unemployed for 27 consecutive weeks or longer. This segment of the workforce is usually thought to be represented by skill mismatches or an unwillingness to work. Like the overall unemployment measure, the long-term unemployment measure is near historic lows (see Figure 4). By this measure, many workers who can work or are looking for work appear to be finding jobs.

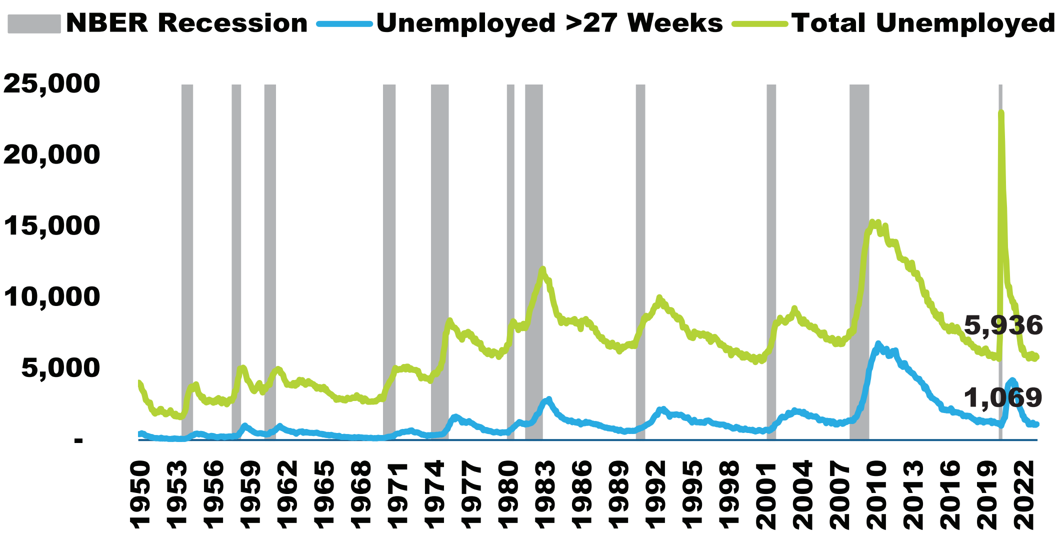

FIGURE 4
Total Number of Unemployed and Long-Term Unemployed Workers (1,000)
Source: FRED as of April 7, 2023. April report shows February 2023 data.

Mismatch of job openings and unemployment rate

The pandemic led to many reevaluating their careers. As discussed earlier, some opted for early retirements, while others went back to school, moved to less expensive areas, or looked for higher paying jobs or more flexibility. Certain sectors of the labor market have been meaningfully impacted by declining demand or a struggle to attract workers. Remote working has changed residency patterns and available labor in certain geographical locations.[22] The US Census found significant changes in transportation, consumer, and residential patterns related to the pandemic lockdowns and remote working.[23] For example, the US Census found that the number of people working from home tripled between 2019 and 2021, and the use of public transport as a share of total commuters halved.[24] In the District of Columbia, over 48% of workers worked from home.[25]

These dynamics have led to a marked shift in the number of job openings compared to the number of available applicants. For perspective, the ratio was 0.2 in April of 2020, which meant there was only one job available for every five unemployed workers (see Figure 5). It has since increased to 1.7 in the latest reading, meaning there were 1.7 jobs available for every unemployed worker. This is a historically high number, which implies a tight labor market. Tight labor markets usually lead to wage inflation.

22 Source: US Census, "Remote Work During Pandemic Shifted Daytime Population, February 2023. A survey of LinkedIn found a 457% increase for remote-work category of paid job advertisements between 2020 and 2021.

23 Source: US Census, "Remote Work During Pandemic Shifted Daytime Population, February 2023.

24 Source: US Census, "People Working from Home", September 2022. The survey results focused on urban areas with populations over 65,000 residents.

25 Source: Ibid.

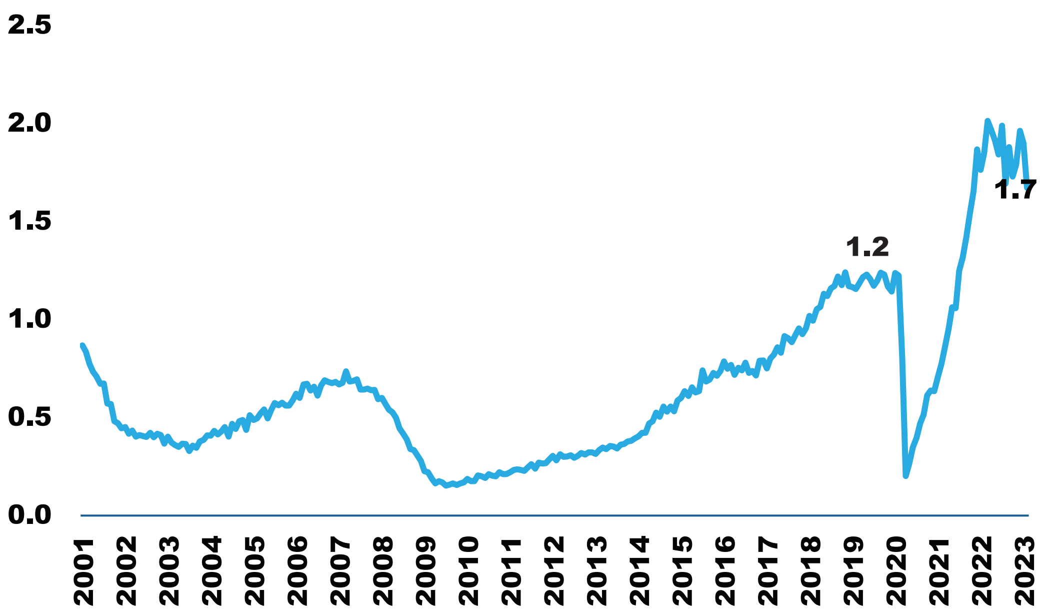

FIGURE 5

Number of Jobs Per Unemployed Worker (2001 -2023)

Source: FRED as of April 7, 2023, and Meketa calculations. April report shows February 2023 data.

Quits, hires, and layoffs

The quit rate (see Figure 6) is at notably higher levels than any time in the past twenty years. Part of that is being driven by the Great Resignation mentioned earlier. In comparison, layoffs, which spiked during the onset of the pandemic, have declined to the lowest levels seen in the past twenty years. In 2022, as major technology companies saw their share prices fall, they announced around 130,000 layoffs.[26] In spite of high-profile layoffs in the tech sector and among some middle-management, the rate of layoffs has yet to indicate any wide-ranging distress in the labor market.

[26] Source: National Public Radio, B. Allyn, "5 Takeaways from the Massive Layoffs Hitting Big Tech Right Now," January 26, 2023. The technology sector is thought to employ around nine million workers.

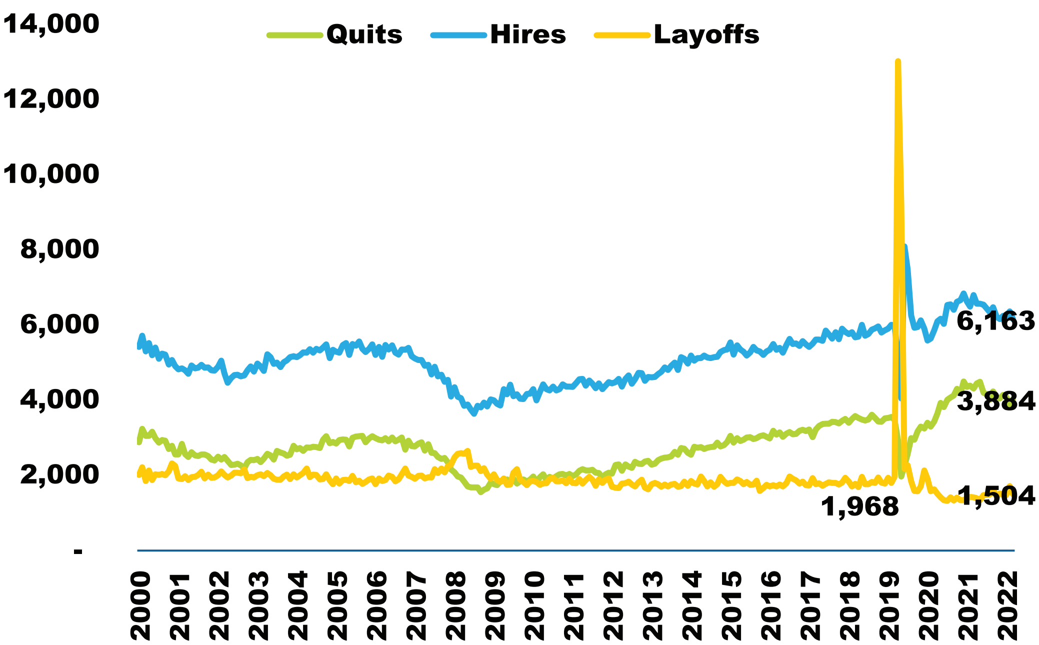

FIGURE 6

Number of Quits, Hires, and Layoffs (1,000)

Source: FRED as of April 7, 2023. April report shows February 2023 data.

Summary

As we look ahead, issues with the labor market will remain key as the Federal Reserve continues to fight inflation. Despite inflation's slow decline, it remains well above the Fed's target of 2%. At this time, it is largely expected that the Fed will continue tightening policy for much of 2023. We will have to wait and see how the Fed's actions continue to flow through the economy.

There is a meaningful risk of a recession in the US given the anticipated effects of the Fed's aggressive monetary policy tightening. If we enter a recession, it is unclear how deep it will be and how long will it run. As we outlined, the demand for workers is still high in the US and workers are scarce, leading to the unemployment rate remaining near historic lows. The current strength of the labor market could soon weaken.

We have noted several factors likely contributing to the labor dynamics in the US, and we will continue to watch these dynamics. It is too soon to know if the US will enter or avert a recession. A strong labor market often pre-dates recessions, and there are unique elements in the current environment related to the pandemic, inflation, and the unprecedented pace of policy tightening. We will have to wait and see if the Fed is able to help land the economy softly or if the aggressive rate hikes will tip the economy into recession.

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