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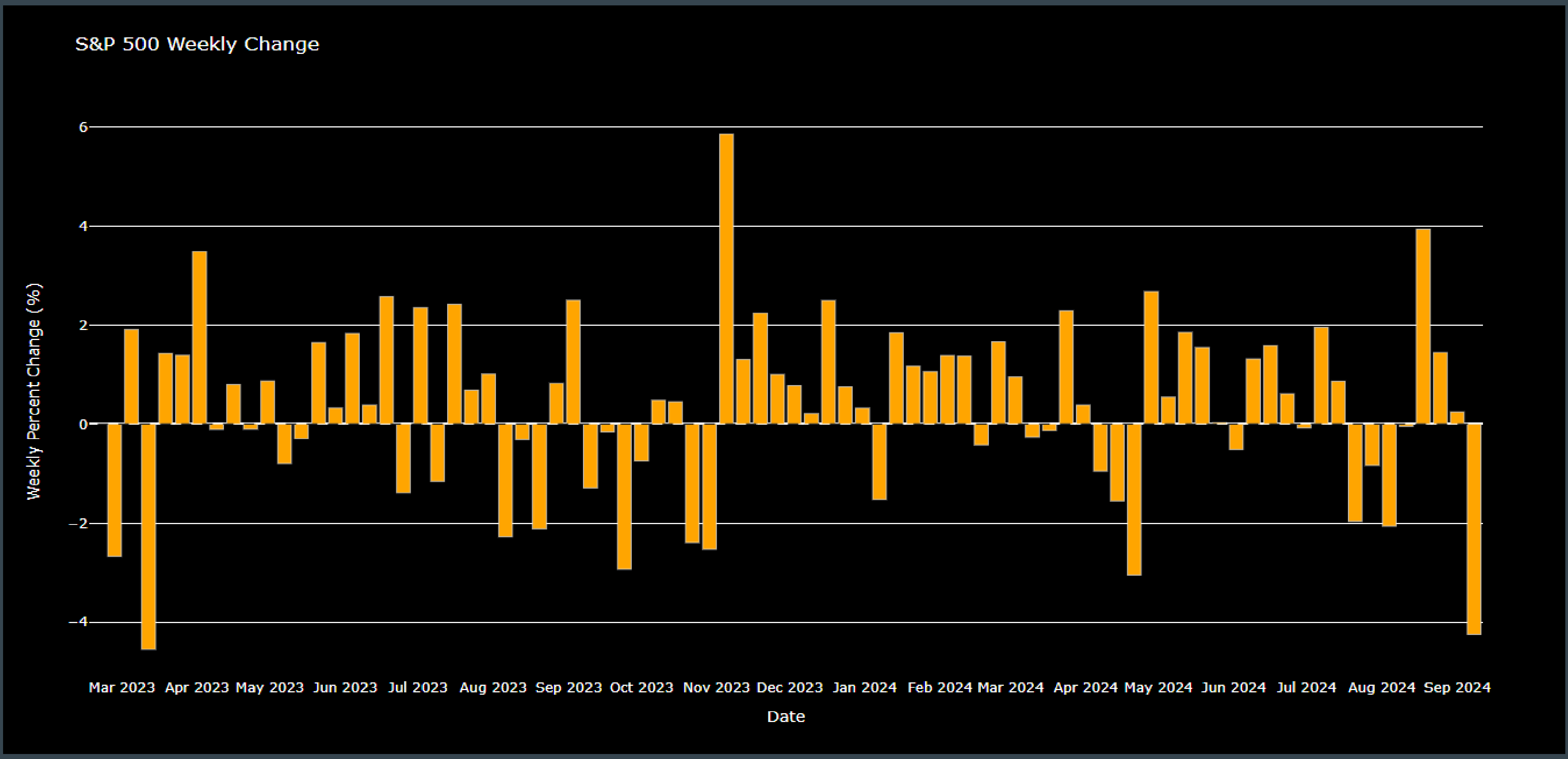
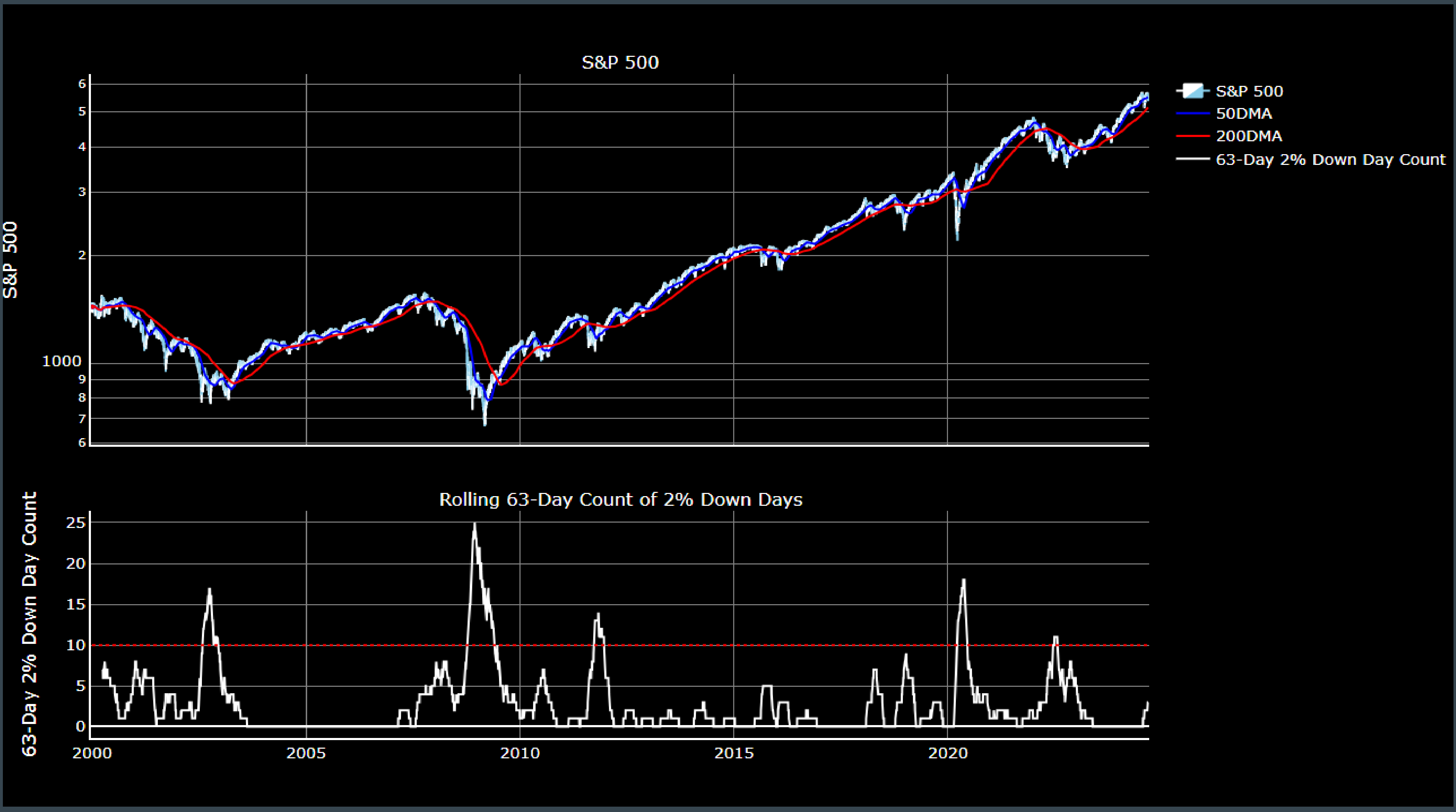
September 7, 2024

Nonfarm Payrolls Are Not Yet Recessionary

This past week, the S&P 500 saw its worst performance since the banking crisis in March 2023, with negative returns largely driven by Friday's Nonfarm Payrolls report. Unlike the SVB collapse, we are not currently facing or nearing a similar crisis. However, we believe the market has overreacted to the latest economic data—something we've anticipated for over a month. The market's focus has shifted away from inflation and is now centered on the labor market, with concerns about economic growth taking center stage. For the past year and a half, bad economic news was often seen as a positive for markets, signaling potential rate cuts from the Federal Reserve. Now, however, bad news is simply bad news, as it fuels fears of an economic slowdown or recession. As a result, investors are increasingly adopting risk-off positions in response to negative data, driving the negative stock-bond correlation that was typical over the last 20 years. The potential downside risk in the markets has become increasingly real.

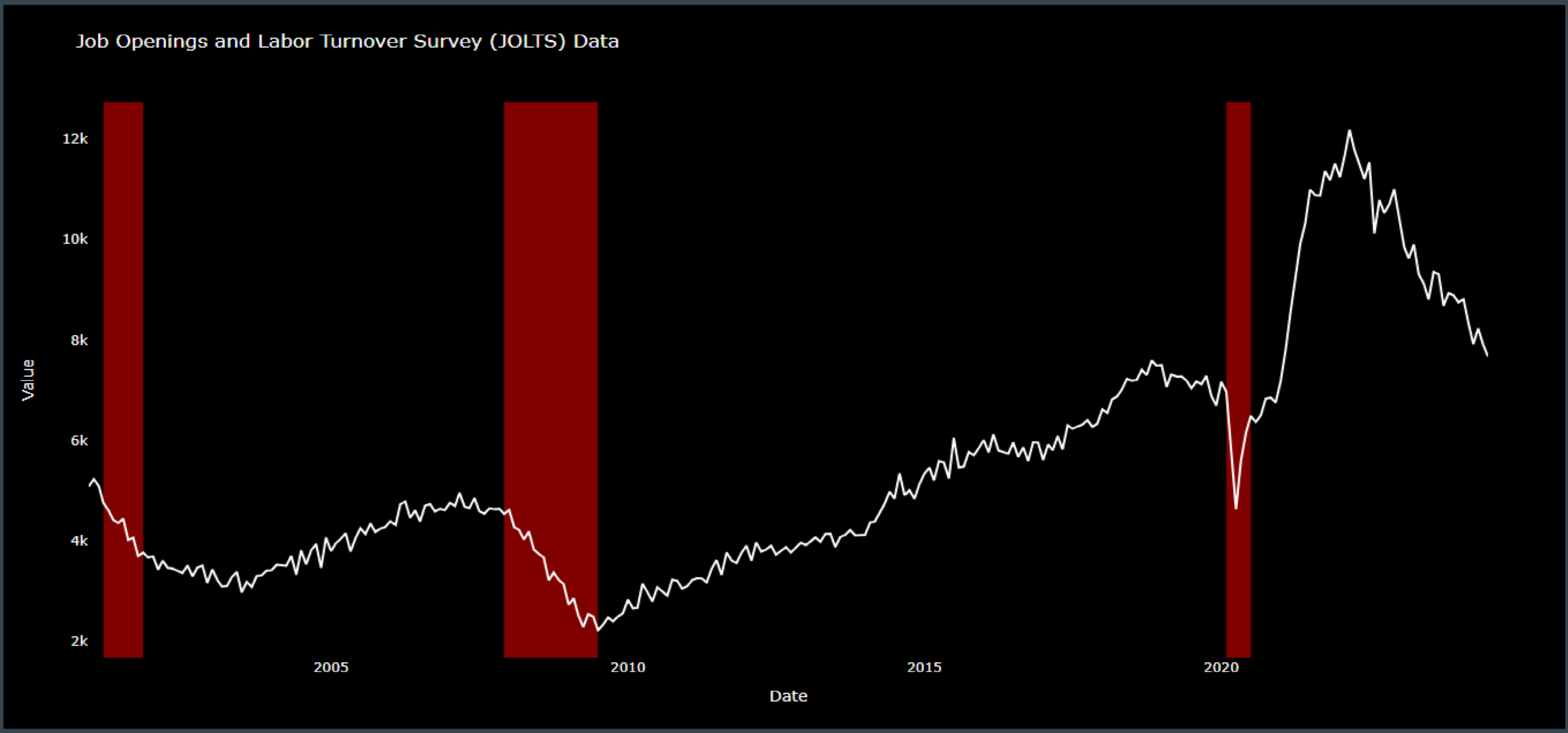


After more than 330 consecutive days without a 2% decline in the S&P 500, we've now seen three such drops in the past 60 days. A few isolated declines aren't necessarily cause for concern, but when they begin to cluster together over short periods, it can signal the potential for a broader market correction.

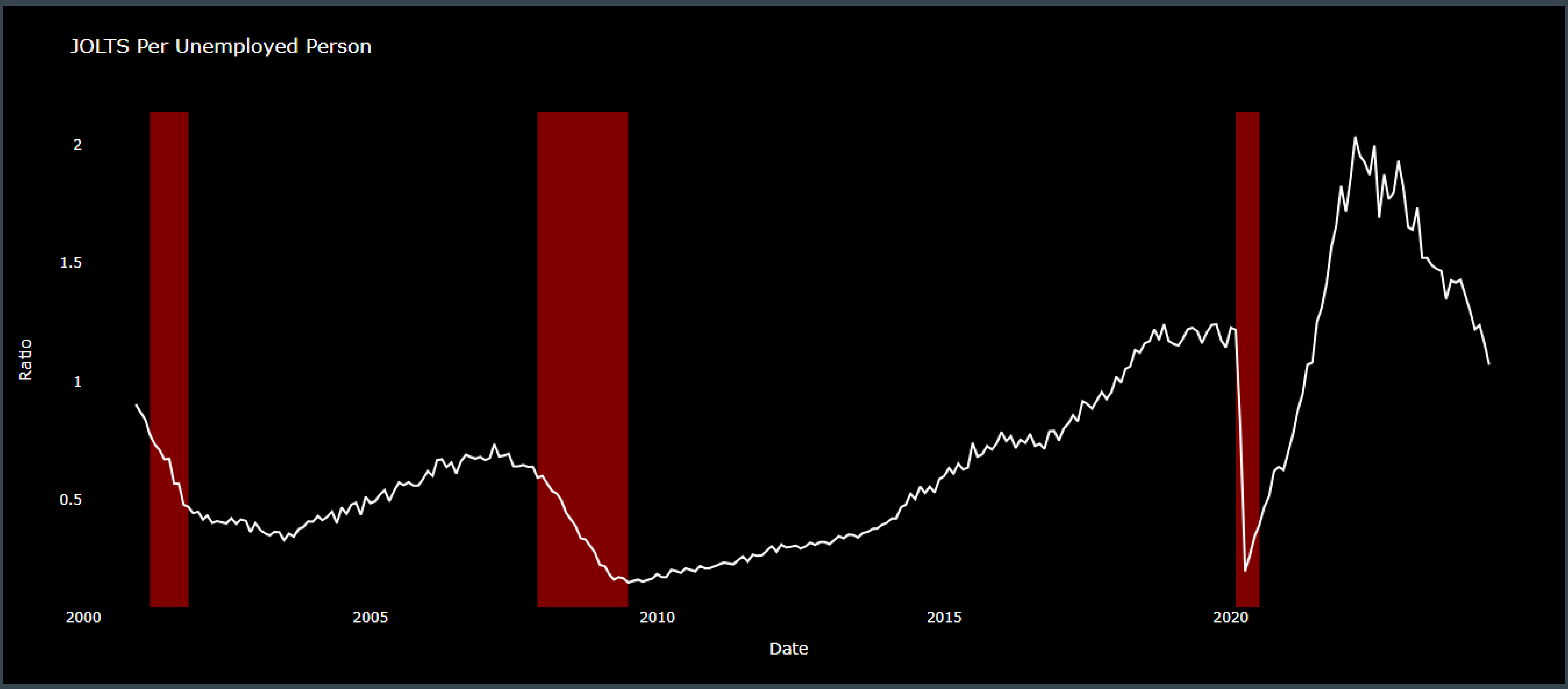


Following this week's economic data, the market is now pricing in a 50-50 chance of a 50-basis point rate cut at the September 18th Fed meeting. However, after hearing from various Fed officials and their comments on the latest data and the labor market, we don't believe the Fed will cut rates by 50 basis points. That said, the Fed rarely makes a move that shocks the market, so a 25-basis point cut seems all but guaranteed. All year, the market has been eager for rate cuts, but now that we're two weeks away, a single cut may not satisfy investors. The market isn't just pricing in 50 basis points at the next meeting—it's also expecting 150 basis points of cuts over the next 6 months and 200 basis points over the next 12. Historically, this level of cutting hasn't occurred without a recession. There are two forces at play here: the market wants aggressive rate cuts, but the Fed won't deliver them unless the data justifies such action. If the data supports this level of cuts, it would likely signal severe economic weakness—leading to declining earnings growth and rising unemployment, which would cause the market to fall anyway. Once again, the market appears to have overpriced the pace of the cutting cycle given the current economic data. Whether or not the Fed's actions will satisfy the market remains to be seen as the upcoming meetings unfold. Volatility is another key theme we've consistently highlighted. The VIX spiked toward 65 before settling back to 15, but by the end of this week, it rose again into the 20s, closing just above 22 on Friday. This move comes as no surprise to us, as we've continually pointed out the seasonality of volatility over the past 20 years. We also touched on technology stocks last week, particularly the "Magnificent 7." We noted that defensive sectors like Utilities, Staples, Real Estate, and Healthcare had been rallying despite the slowdown in growth names, which helped the market test its previous highs. However, we warned that if tech stocks didn't recover, another down leg was possible. This week, tech continued to decline, contributing to the broader market's pullback. The XLK, XLC, and the Magnificent 7 (on an equal-weighted basis) are now all sitting below their 50-day moving averages. The longer they remain below these levels, the more likely we are to retest the previous correction low of 511.83 on the S&P 500 (SPY). While defensive sectors have been a safer place to be, they will only help mitigate losses in a down market due to their lower beta. This underscores the risks associated with heavy market concentration—when the biggest names struggle, the whole market feels the impact.

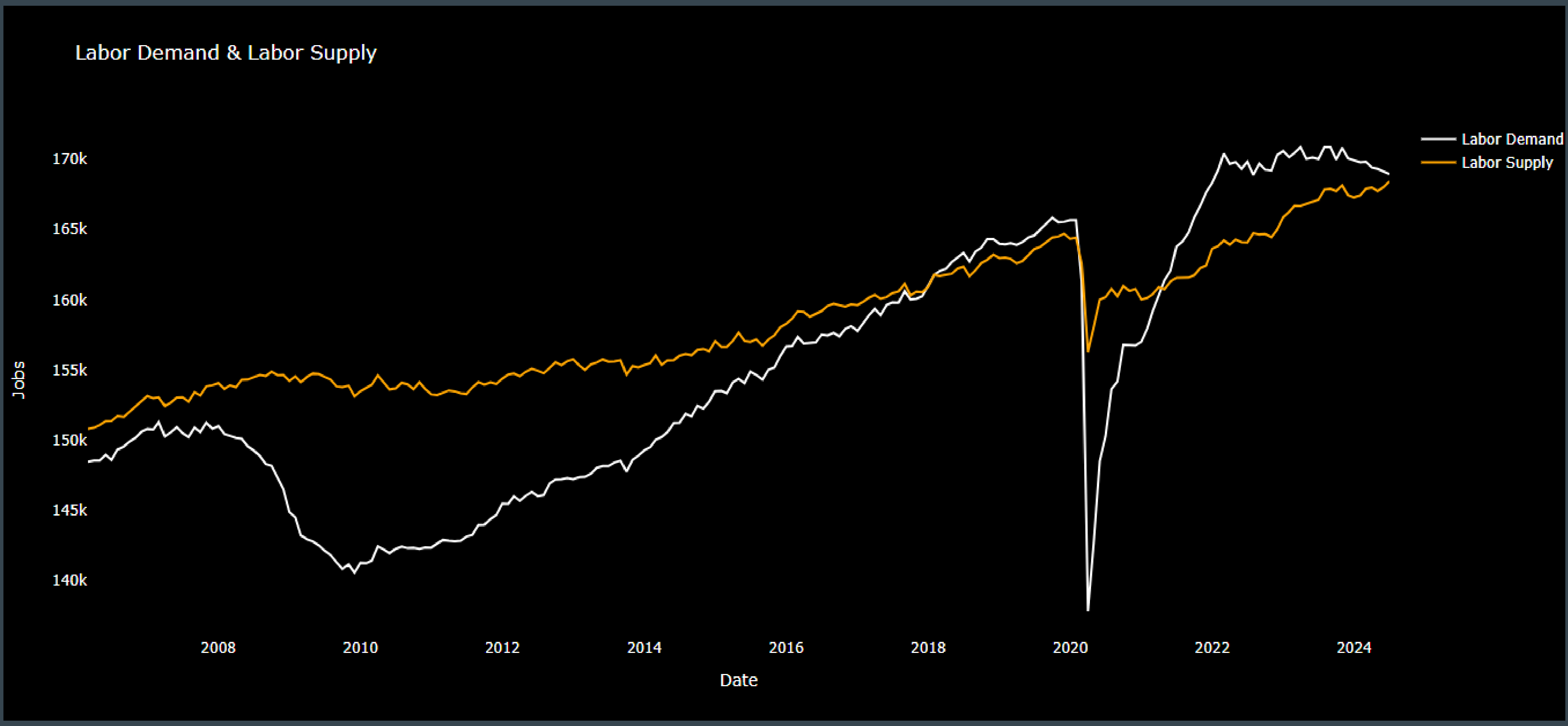
This week's economic news was all about the labor market. The JOLTS (Job Openings and Labor Turnover Survey) report, released on Wednesday, showed 7.67 million job openings—240,000 fewer than last month, accounting for revisions. While this survey is often criticized, it remains closely watched by the Fed. However, it's important to note that response rates for the JOLTS survey have dropped to just 23%, meaning the sample may not be fully representative of the broader labor market. That said, job openings are now slightly above 2019 levels, which the Fed interprets as a sign that the labor market has largely normalized. This is why the Fed has expressed concerns about further cooling in the labor market. The trend toward 2019 levels suggests we've returned to pre-pandemic conditions.



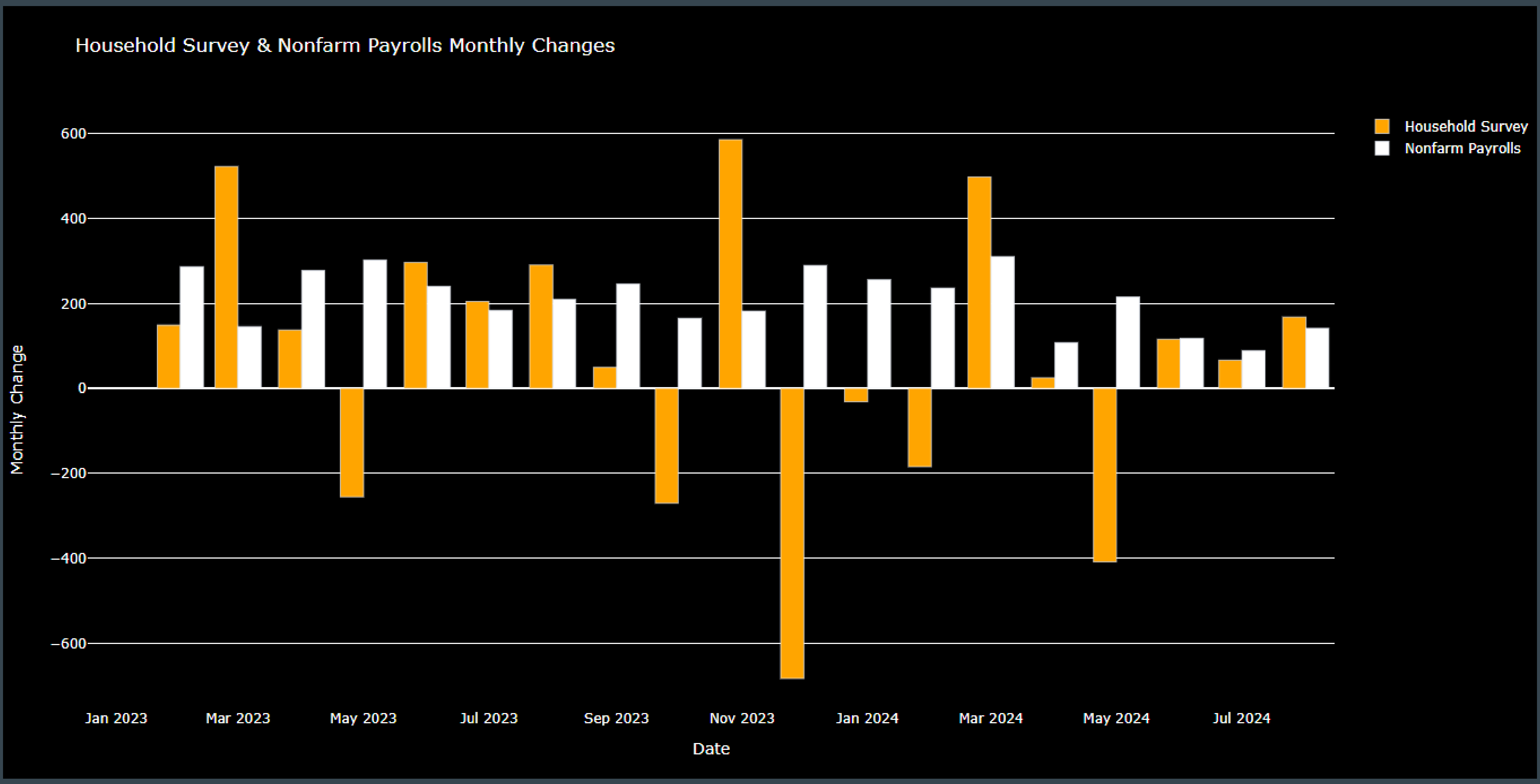
The ratio of job openings to unemployed persons has dropped to 1.07, which is below the levels seen during the consolidation period from late 2018 to early 2020. Any further decline in job openings could leave new entrants to the workforce without sufficient opportunities, potentially putting upward pressure on the unemployment rate.



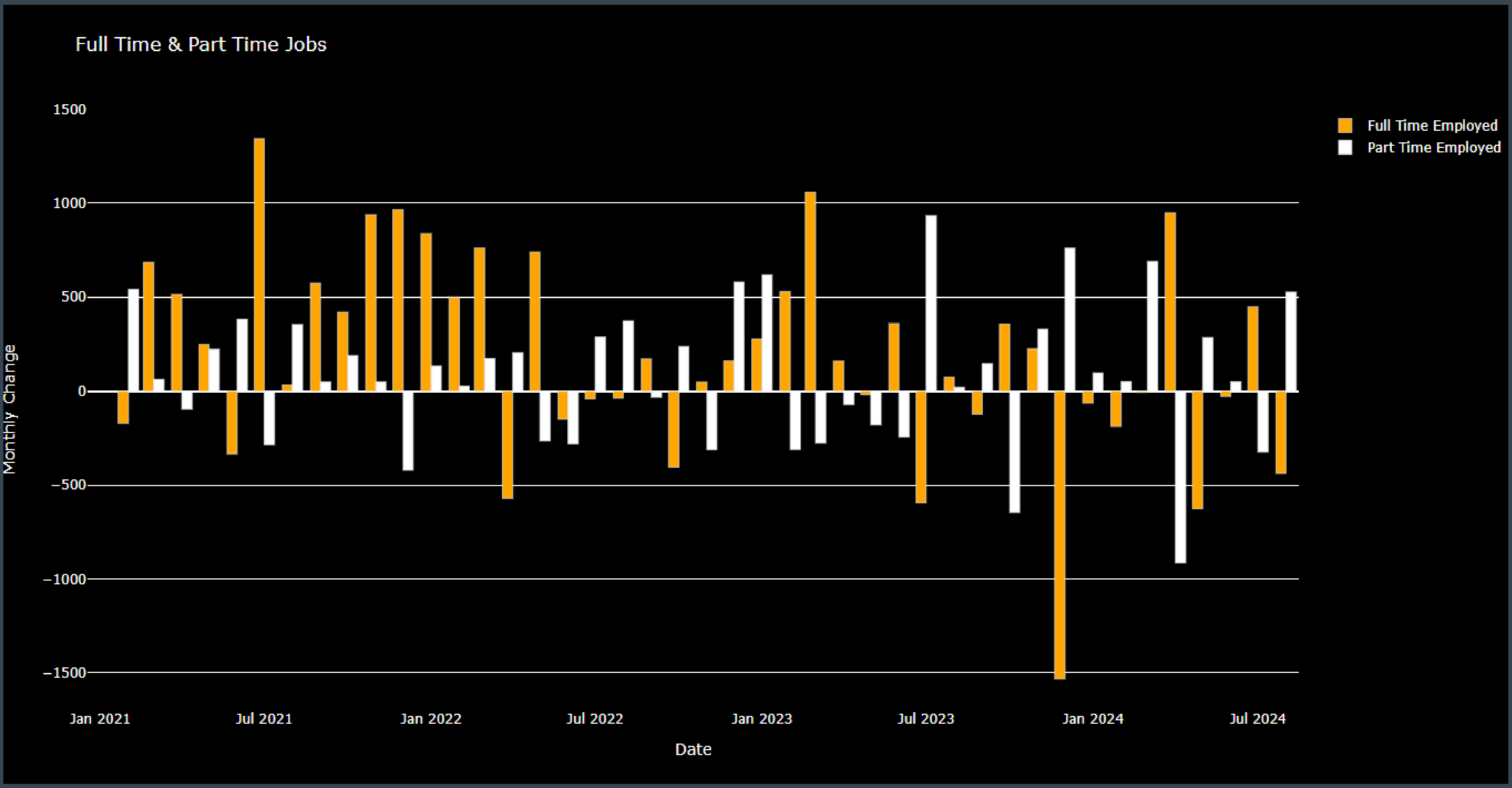
Labor supply and demand are nearly back in balance, based on the data we monitor. Labor supply is simply defined as the labor force, while labor demand includes those currently employed plus job openings. The large gap that has persisted since 2021 has nearly closed.



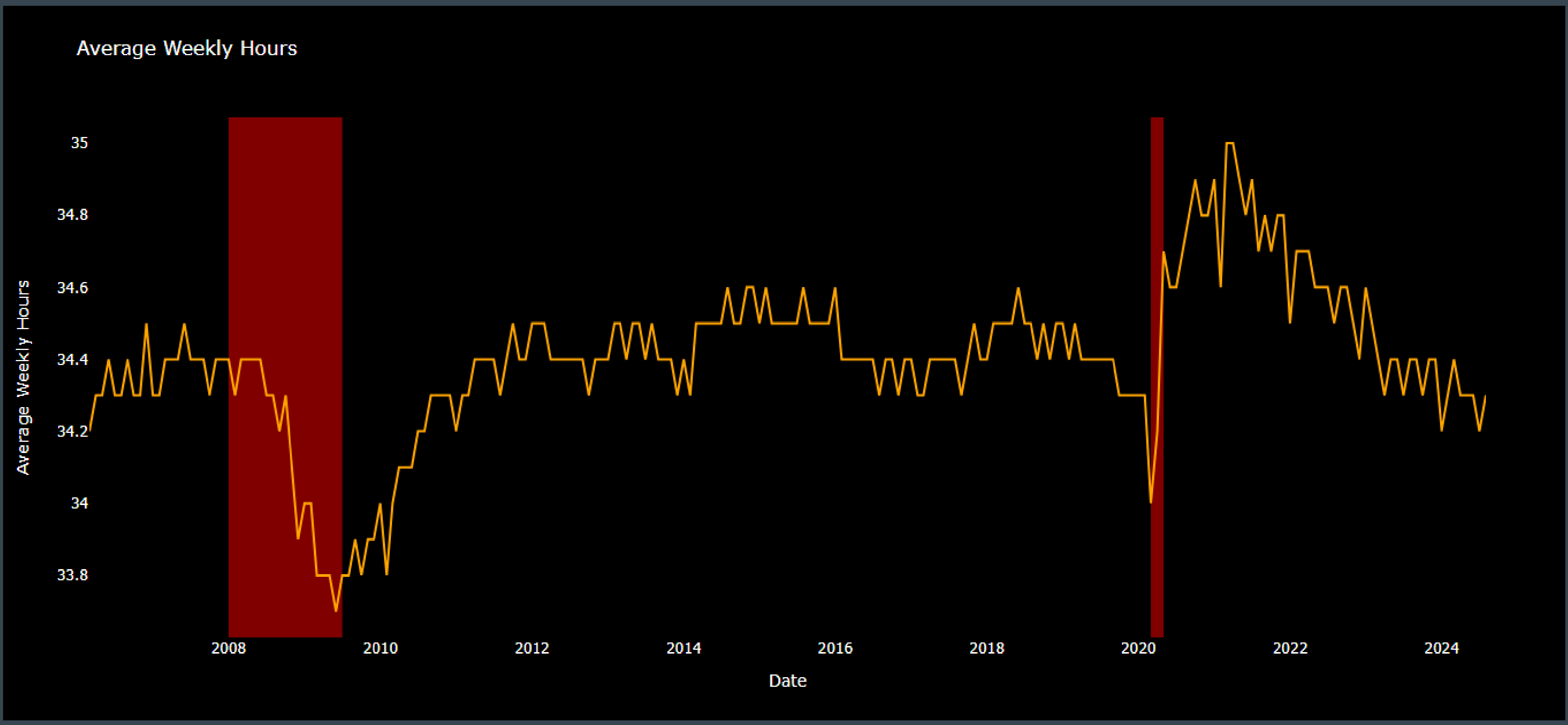
Nonfarm Payrolls drove the market lower on Friday and pushed bond yields below the key 3.78% support level we've been emphasizing over the past month. While we believe the bond market is starting to price in the possibility of a recession, the stock market still seems to be pricing in a 0% chance. Yields breaking below our support level don't necessarily mean we're forecasting a recession yet. As we previously noted, initial jobless claims would need to approach 300K for a clearer recession signal. However, this move suggests that investors are now assigning a non-zero probability to a recession. Payrolls came in at 142K, slightly below the expected 161K, but not a bad print—similar to last month's 114K. Both figures are close to pre-COVID averages, signaling a "normalizing" labor market. What likely spooked the market was the 86K downward revision to the previous two months' numbers. At the same time, the Household Survey showed a gain of 186K jobs for August. Despite these softer prints, they are likely strong enough to defer any consideration of a 50-basis point rate cut in September.



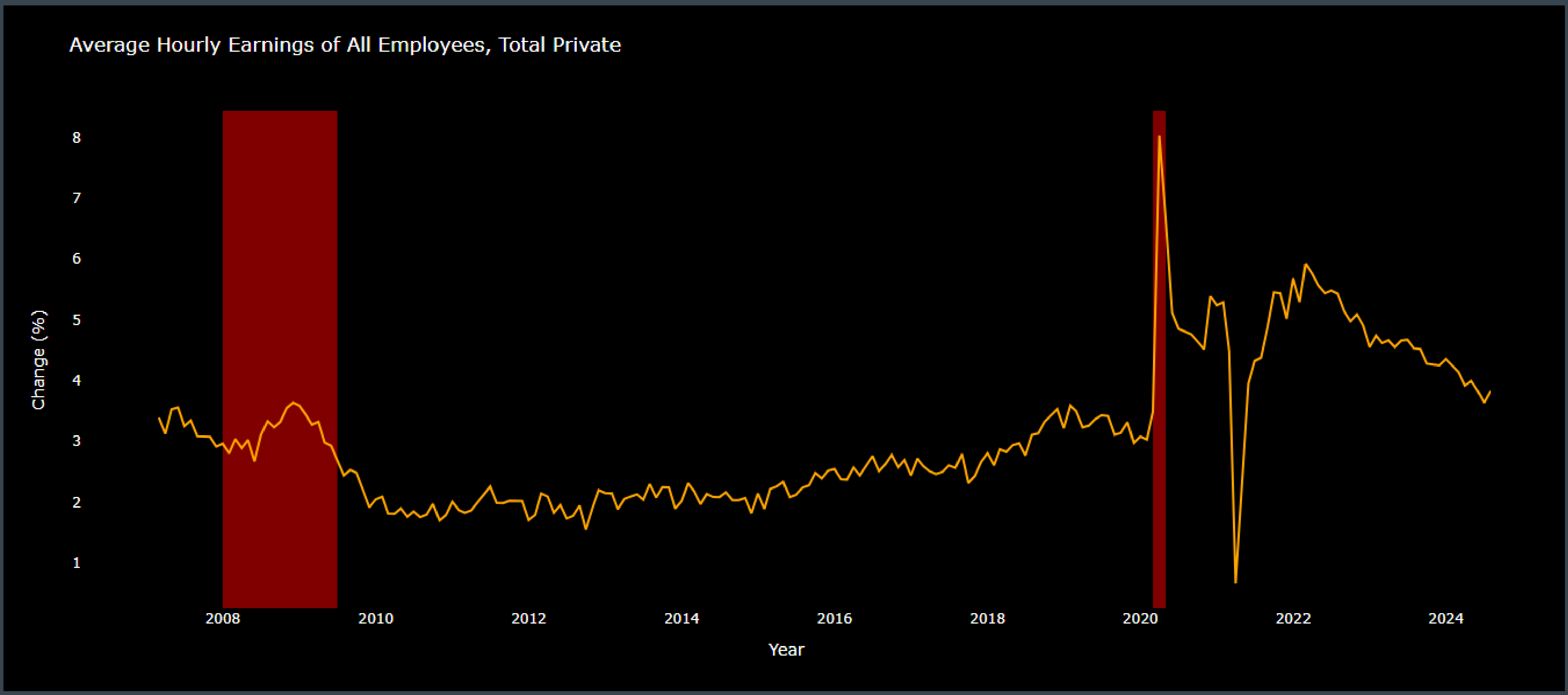
Under the surface, the composition of the net employment gains in August show there was a loss of 438K full-time jobs, offset by a gain of 527K part-time jobs. Since March 2023, this trend has become more pronounced, with a cumulative loss of 1.2 million full-time jobs and a gain of over 1.5 million part-time jobs.



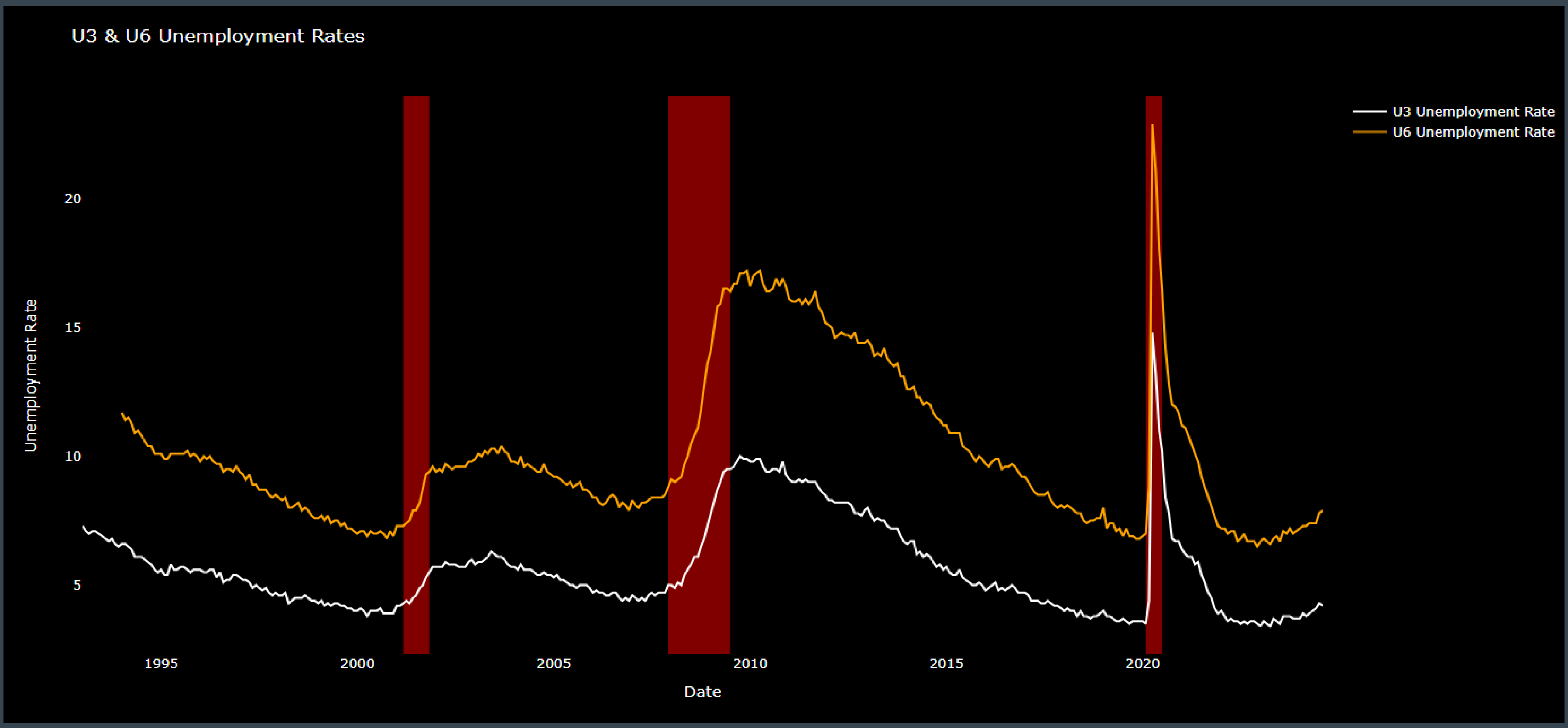
While the composition of jobs created is mixed, and in our view not skewed positively, there was a bright spot in the increase in average weekly hours worked. It rose from 34.2 to 34.3, and when extrapolated across the 160+ million people employed, this increase is very supportive of incomes and consumption, both of which have a direct impact on GDP growth.



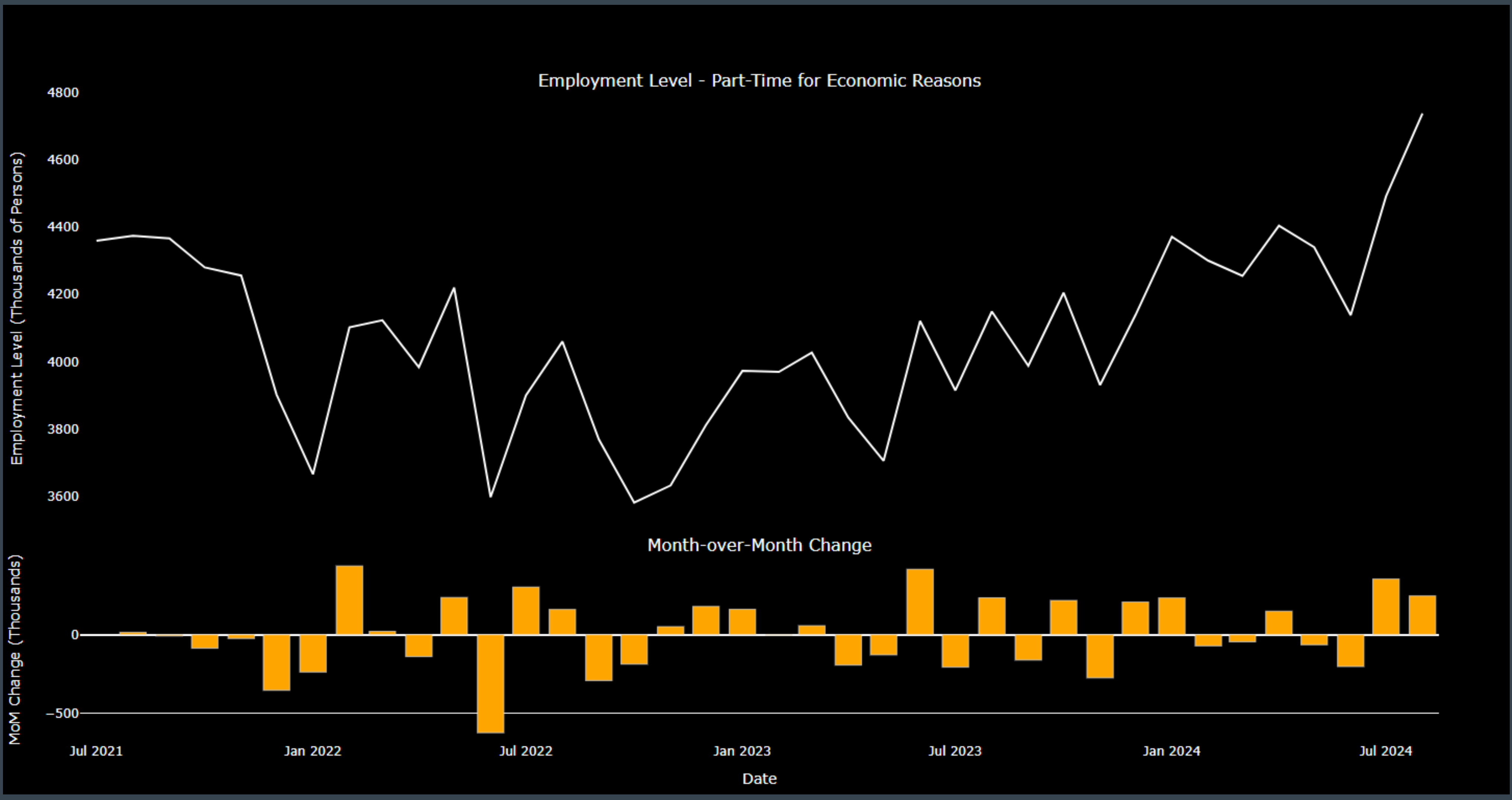
In addition to the rise in weekly hours, average hourly earnings also increased, with the year-over-year measure climbing from 3.6% last month to 3.8% this month. So, there was something for everyone in this jobs report. Whether you're a bull or a bear, both sides can point to aspects of the data that confirm their views on the labor market.



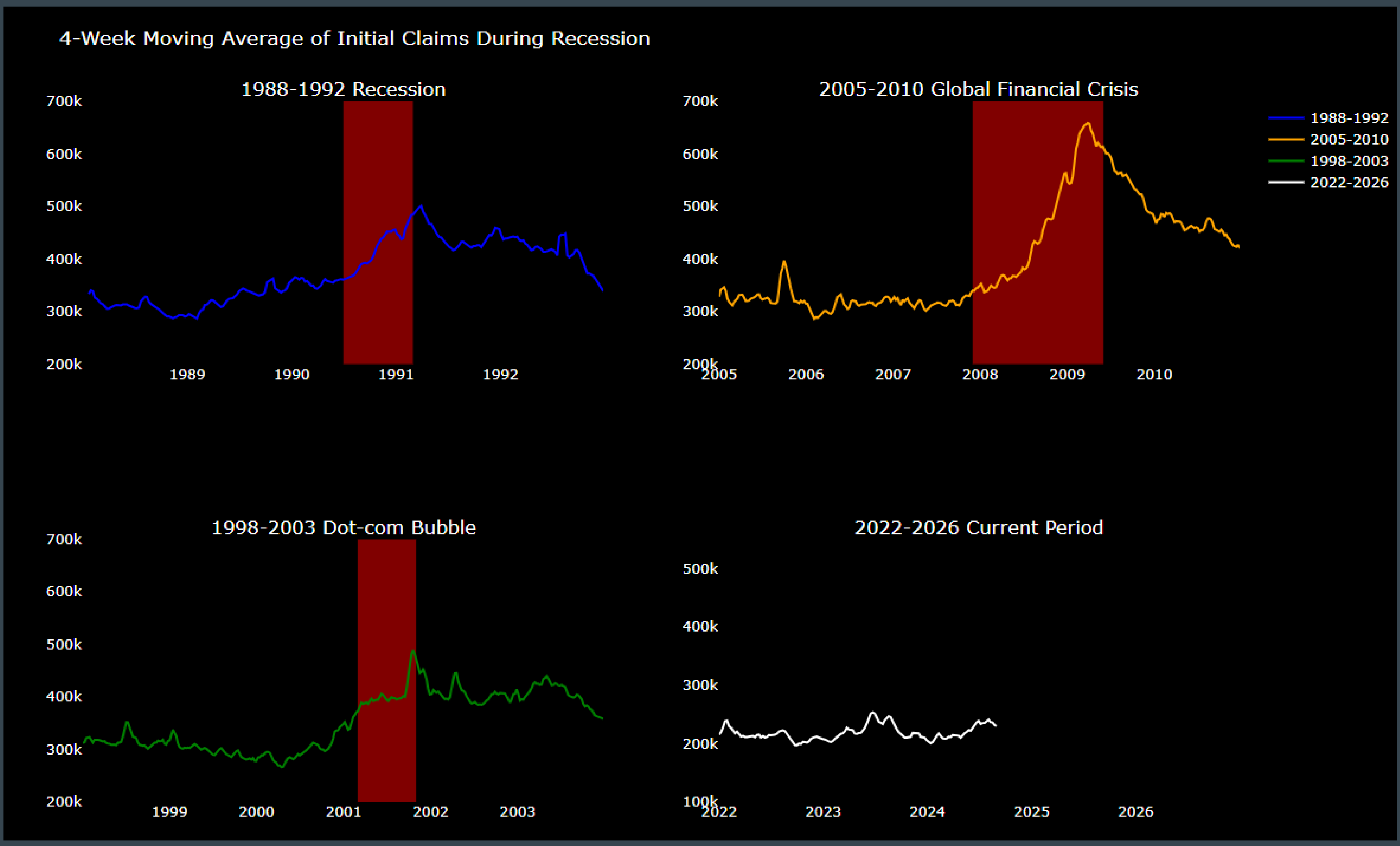
There was even a divergence between the U-3 and U-6 unemployment rates. The U-3 rate, which is the headline figure most often quoted, fell from 4.3% to 4.2%, in line with expectations. However, the U-6 rate, which includes discouraged workers (those who haven't applied for a job in the last four weeks) and those working part-time for economic reasons, rose from 7.8% to 7.9%.



We dug a little deeper to understand what caused the divergence, pushing the U-6 rate higher. It turns out that the number of people employed part-time for economic reasons increased by 246K in August and 353K in July. This signals potential stress within the economy, as more individuals are being forced to take on part-time or second jobs. However, given the mixed data we received for August, it's important not to draw conclusions from this single datapoint. It's just one piece of a broader picture, but certainly something to keep an eye on moving forward.



To conclude this week's article, we took a deeper dive into Initial Jobless Claims, since two of the signals we were watching—yields falling below 3.78% and oil dropping below $70—have already triggered. We examined three past recession periods: 1988, 1998, and 2005, and compared the 4-week moving average of jobless claims from those times to today's levels. There has been some concern over the rise in Initial Claims throughout the summer, but we previously attributed this to seasonality, as it aligned with patterns from prior years. Our study confirmed that the 4-week moving average doesn't typically reach recessionary levels until it climbs to around 330K. Currently, we're still down around 230K, meaning there’s still some distance before this data starts to raise alarms for us.


4-Week Moving Average of Initial Claims During Recession
1988-1992 Recession
2005-2010 Global Financial Crisis
1998-2003 Dot-com Bubble
2022-2026 Current Period
1988-1992
2005-2010
1998-2003
2022-2026
700k
600k
500k
400k
300k
200k
100k
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1990
1991
1992
2005
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