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US Macroeconomics

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Weakness Below the Surface

Nonfarm payrolls rose a higher than consensus 275k, but this was after a large 167k in downward revisions. Private payrolls were up a lesser 223k. **Government continues to be a large contributor to employment**, adding 52k workers for the second month in a row. But the government's impact on hiring is even larger than it appears.

Employment within healthcare and social assistance is heavily impacted by federal spending mandates. Notably, the former category was the single largest private sector contributor in February, adding 91k jobs. Private payrolls excluding healthcare and social assistance were up just 132k.The leisure and hospitality sector was the second largest contributor accounting for 58k jobs. The construction sector was a distant third, adding 23k jobs.

Three nonfarm payroll observations are necessary. One, the **downward revisions reinforce our view that employment gains are being overstated**. Remember that a consistent pattern of downward revisions began last year. But the full extent of excess job gains, which we suspect is due to net birth/death adjustments, will not be known until there are further benchmark revisions over the next couple of years.

Two, temporary hiring was down 15k after January was revised into negative territory. "Temps" are now down for 23 consecutive months, which means that future labor demand continues to rapidly cool.

Three, **residential construction employment is overstaffed by upwards of 1 million workers**. Pending home sales and housing affordability are near all-time lows. Housing starts are down 20% from around when the Fed began tightening. There are too many construction workers given the level of activity. Bloated payrolls may be due to labor hoarding. Previous pandemic-related restrictions and supply-chain issues made it difficult to hire workers and complete projects.

Preserving the current level of residential construction employment would require either a sharp decline in mortgage rates or home prices. But **mortgage rates are only likely to plunge if there is a recession**, and a large drop in home prices itself would likely cause a recession.

Regarding the unemployment rate, it rose two-tenths to 3.9%. This re-triggers the half percentage point recession rule that had initially occurred last year before being revised away. The unemployment rate may be the most important economic variable going forward.

Troublingly, the increase in the unemployment rate was due to a 184k *decline* in Household Survey employment and a 334k increase in unemployment. And private wage and salary workers were down 151k. Labor force participation, which had been rising the last several years, has flattened out to a low 62.5% for the past three months.

Average hourly earnings were up just a tenth after a large January gain was revised down (from 0.6% to 0.5%). Over the past 12 months, earnings are up 4.3% compared to 4.4% in January. News that the labor quits rate fell to a five-year low means that growth in labor compensation is poised to slow sharply in the months ahead.

In terms of the Fed, **the February employment results do not change anything for the March FOMC meeting** and are unlikely to impact May unless the next employment report shows a further significant rise in the unemployment rate and a sharp slowing in hiring. The June 12th FOMC meeting remains the most likely start for rate cuts which are expected to continue through 2023 and into 2024.

The current 5.25% to 5.5% funds rate needs to fall to around 3% (or lower) if the current widespread expectations of a soft landing are not met. Stay tuned.

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