INVESTMENT INSIGHTS

Analysis, Insights, and a Different Perspective

August 2023

KEY POINTS

- The post-COVID economic recovery resulted in a strong labor market, high wage pressures, and inflation.
- The strength of inflation has started to cool down from its peak in 2022 due to the high Federal Funds Rate.
- The Federal Reserve wishes to further cool down the labor market to decrease wage pressures and overall inflation.
- The Federal Reserve expects to increase the Federal Funds Rate at the end of the month to calm the labor market and inflation further.

UNDERSTANDING RECENT LABOR MARKET TRENDS

EXPLAINING THE LABOR MARKET

Over the past month, there have been mixed headlines about the strength of the labor markets. The labor market refers to the supply and demand of labor nationwide. Employees represent the supply side—they offer the labor for open jobs; employers represent the demand side—they offer job opportunities. One key factor that affects the labor market is the unemployment rate. The unemployment rate is a key factor because when the economy is going through a stressful situation, this will cause the demand for labor to lag behind the supply of labor. For example, companies (demand side) trying to navigate through difficult economic times at their top speed will reduce their hiring of employees (supply side).

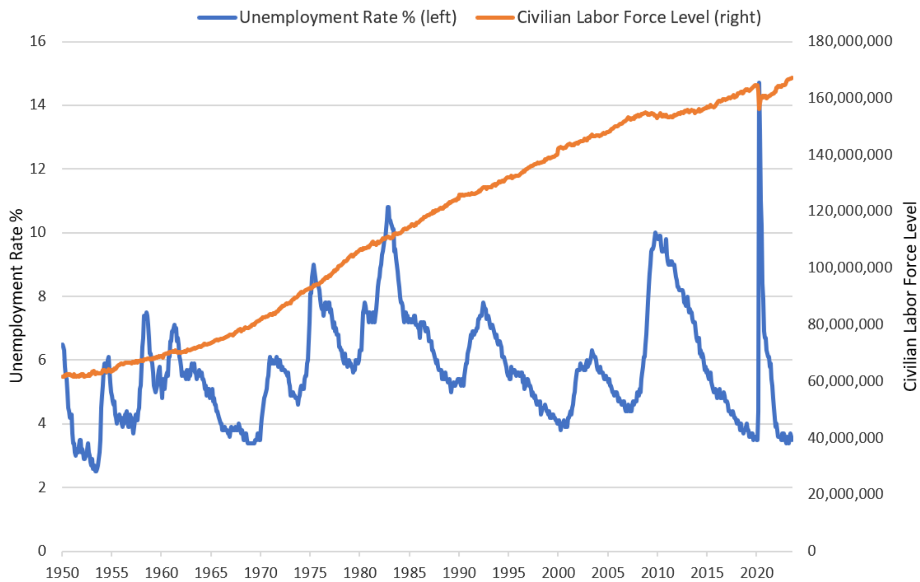
THE UNEMPLOYMENT RATE

Before we talk about unemployment, it is crucial to understand the basics of the U.S. labor force. A common misconception is that the unemployment rate is the total number of people without a job divided by the number of people in the country. Instead, there are numerous ways to define the labor force.

According to the U.S. Census Bureau, the total population of the United States was approximately 333 million in June 2023. However, the total population is not used to calculate the unemployment rate. The civilian noninstitutional population is used instead, which excludes people under 16, inmates at institutions, and those on active duty in the Armed Forces. The civilian noninstitutional population, or the population level, was approximately 267 million in June 2023.

Cornerstone
WEALTH MANAGEMENT LLC
A Registered Investment Advisor

Next, individuals who are not employed and have not actively looked for work in the past four weeks are excluded from the number of people in the labor force. The civilian labor force (orange line below) was approximately 167 million in June 2023. The labor force is the total number of people available for work. The labor force is composed of two components: the number of employed and unemployed people. The unemployment rate (blue line below) is the number of unemployed divided by the labor force. With these definitions and corresponding numbers in mind, we are ready to understand the unemployment trends.

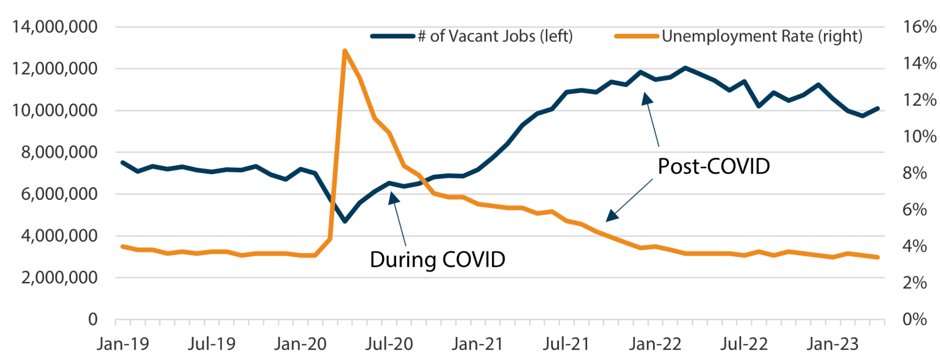


Source: U.S. Bureau of Labor Statistics, Unemployment Rate, retrieved from FRED, Federal Reserve Bank of St. Louis and U.S. Bureau of Labor Statistics, Civilian Labor Force Level, retrieved from FRED, Federal Reserve Bank of St. Louis.

THE IMPACT OF COVID ON THE LABOR MARKET

The headlines about the labor market are confusing in current news; for example, many headlines are reporting that the labor market is cooling down, but it is still strong and favorable for workers.[1] Other headlines question if the cooling labor market is bad[2], so let us take a step back. The graph below shows that COVID increased the unemployment rate (orange line) while the number of vacant or available jobs (blue line) decreased. The unemployment rate increased due to people being unable to work or go to public spaces. After COVID slowly passed, this trend completely flipped, as seen below. This shift led to a scenario where there is a surplus of available jobs compared to job seekers, causing a high demand for workers and establishing a robust labor market. Since employees had much more flexibility and career choices, employers had to compete for more for their workers. This flexibility heightened competition and drove up wages, creating wage pressure. As companies spent more on wages, their overall costs increased, necessitating a rise in the prices of their goods and services — known as inflation. Thus, wage pressure can directly influence inflation.

NUMBER OF VACANT JOBS VS. UNEMPLOYMENT RATE



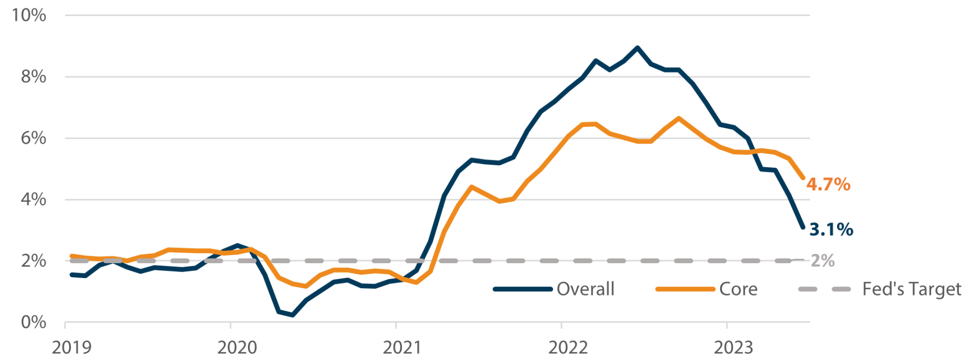
Source: Organization for Economic Co-operation and Development, Total Unfilled Job Vacancies for the United States, retrieved from FRED, Federal Reserve Bank of St. Louis and U.S. Bureau of Labor Statistics, Unemployment Rate, retrieved from FRED, Federal Reserve Bank of St. Louis.

1 CNBC - The job market is still favorable for workers. 'You're in a lucky position,' economist says.
2 NPR - The job market is cooling but still surprisingly strong. Is that a good thing?

RECENT NEWS ABOUT INFLATION

Now let us shift gears toward inflation. The graph below shows that inflation peaked at 9.1% a little over a year ago. Many key factors led to this, such as the wage pressures we just discussed and Russia's invasion of Ukraine, causing the price of energy goods to increase drastically. The labor market also directly affects the inflation rate through wages because when the labor market is strong, employers pay more wages to more employees, increasing inflation. The Fed has stated that one way to combat high inflation is by slowing down the rate at which wages increase. If wage growth continues to increase, so will inflation. Economists around the nation are saying that we need the labor market to slow down to bring down inflation. June's decrease in job growth shows that the labor market is cooling off.

CONSUMER PRICE INDEX - CHANGE FROM A YEAR

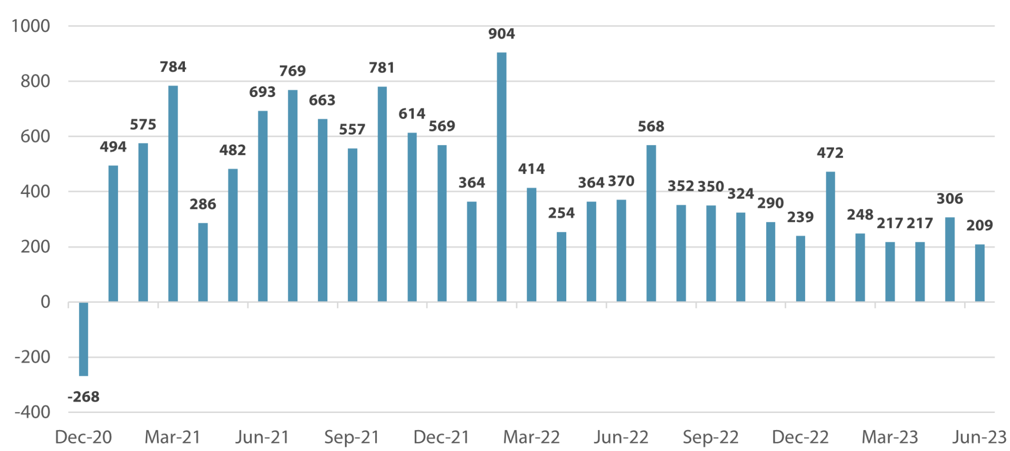


Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average, retrieved from FRED, Federal Reserve Bank of St. Louis and U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average, retrieved from FRED, Federal Reserve Bank of St. Louis.

LABOR MARKET SLOWDOWN = LOWER INFLATION

Returning to the current headlines of the labor market, it may seem alarming that it is slowing down, and the number of jobs created is less than expected. However, as previously explained, this labor market slowdown will help reduce wage pressures and cool inflation. Nonfarm payrolls, a monthly statistic that records the number of people employed in the U.S., says that the number of jobs has only increased by 209,000 in June. While still positive, you can see below that this is the least amount of job growth since December 2020.

JOBS CREATED (THOUSANDS)

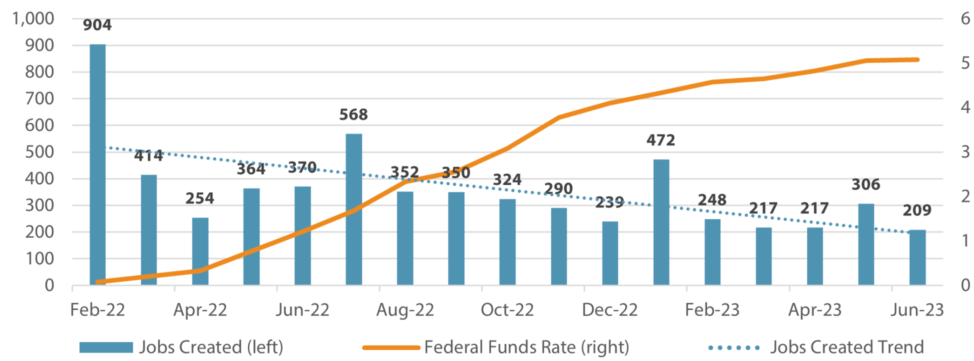


Source: Bureau of Labor Statistics

THE FEDERAL RESERVE'S ROLE

Now we can look at where the Federal Reserve and its set interest rates come into play. The Federal Funds Rate (FFR) is a rate set by the Fed, and it is the target interest rate that all banks follow when borrowing and lending money. A high-interest rate increases the cost of borrowing money, leading to reduced spending and less overall economic growth. As seen in the graph below, as the FFR increased (orange line), the overall strength of the labor markets (dashed blue line) decreased. This decrease demonstrates how the Fed, and their rates, appear to have impacted the labor market.

JOBS CREATED VS. FEDERAL FUNDS RATE



Source: Bureau of Labor Statistics and Board of Governors of the Federal Reserve System (U.S.), Federal Funds Effective Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis.

Another big headline is that the Fed just raised the Federal Funds Rate to 5.5%. Even though the decrease in job growth in the labor market was larger than most economists expected, they still consider it to be at a healthy level. Therefore, believing the labor market is healthy and can handle another rate increase, we have seen the highest rates in the last 22 years.[3]

THE LONG-TERM VISION

The Fed's primary goal is to cool down the economy and return inflation to its long-term goal of 2%. They believe the labor markets will help the economy to slow down. While some are concerned that the Fed may be over-tightening, many economists believe that the labor market is still strong. For example, Andrew Hodge, Senior Economist at the International Monetary Fund, stated that the labor market can sustain yet another rate increase and how crucial this is to the long-run goal that the Fed has of 2% inflation and stable job growth.[4] If the strong demand for labor is not hindered too much by the Fed's recent hikes, it can bode well for the economy overall, as these hikes will cool wage-driven inflation without completely halting economic growth. Given that most market participants expect that we are in the final stages of the rate hiking cycle, the cumulative effect of the rate hikes in the next few months will be key in determining the direction of the U.S. economy in the near future.

3 Wall Street Journal
4 International Monetary Fund