September Payroll Preview

Demand is strong, did supply improve with the end of expanded benefits and school reopening?

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The September Employment Situation Report

Let us take as a starting point, a speech by NY Fed President Williams following the August employment report. Williams is the most influential member of the dovish wing of the FOMC, and he described the labor market as having strong demand but supply constrained. I expected the Fed doves to be concerned about the expiration of expanded unemployment benefits and wanting to wait to see if caregivers returned to work following school reopening. Instead, Williams' focus on the labor market 'bottlenecks' was a turning point for monetary policy. With this in mind as we analyze the report on Friday, the headline takes on less significance than do measures of labor slack.

Consequently, because the household sector is in a very strong position to drive consumption, market expectations of the monetary policy reaction to the employment report is our primary focus. In other words, while the market has become concerned about inflation causing demand destruction, this risk is unfounded, at least in the near term, and will pass. The equity market pullback began with the shift in Fed policy, so the report should be viewed in terms of what it means for Fed policy more so than the implications it has for economic growth. We believe the FOMC is committed to a November taper announcement and reduction of purchases immediately after the November 3rd meeting. Nonetheless, a strong report is likely to further steepen the yield curve, increase real rates and raise the terminal funds rate, trends that began following the FOMC meeting. In former NY Fed President Bill Dudley's Bloomberg interview and Bloomberg editorial this morning he articulated a theme we have been focused on since early in the pandemic: he believes the Fed is fighting the last war and could find itself raising rates aggressively. Therefore, while a strong report does not mean much for the timing of the taper other than to perhaps convince a few holdouts that do not

expect it to begin in November, it will strengthen Dudley's case. On balance, a strong report is unlikely to be equity or bond market friendly (good is bad).

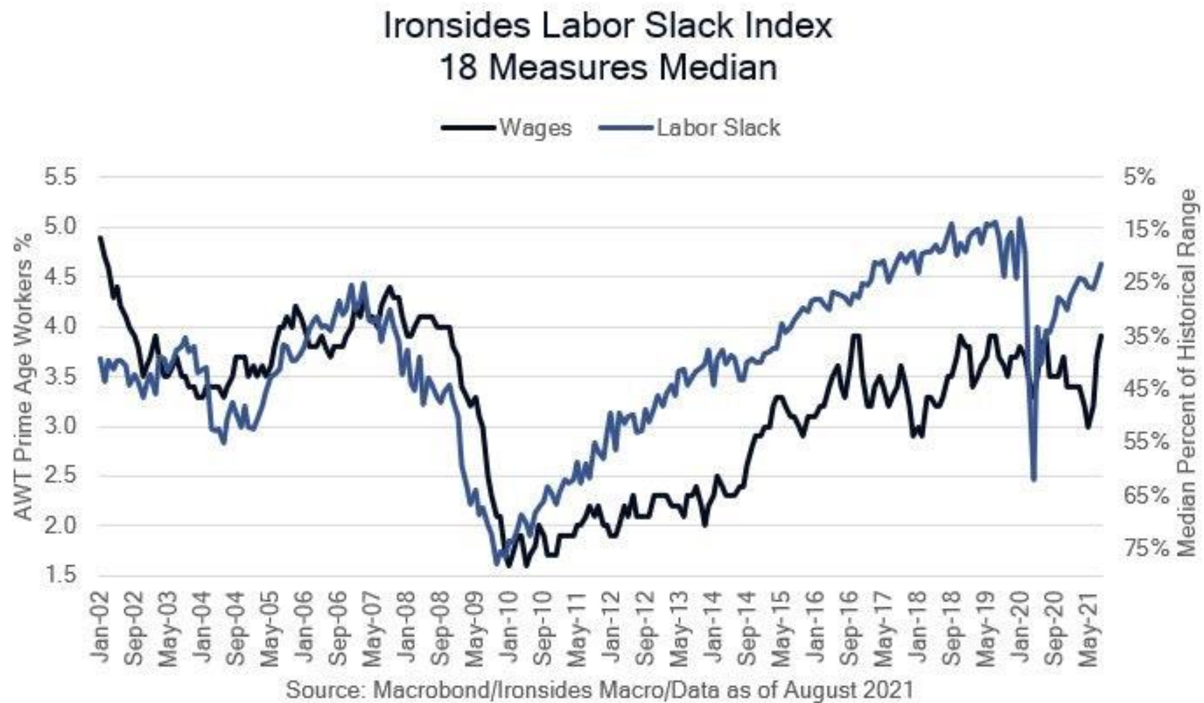

Figure 1: Our slack index is above the peak for the '00s expansion.

Here are the measures of labor market slack included in our slack index that will be released on Friday and their August & July readings.

U3 Unemployment Rate 5.2% v 5.4% - Less Slack

U6 Underemployment Rate 8.8% v 9.2% - Less Slack

Short Term Unemployment (<5 weeks) of total 24.5% v 25.9% - More Slack

Long Term Unemployment (>27 weeks) 37.4% v 39.3% - Less Slack

Participation Rate Prime Age (25-54) Men 88.4% v 88.3% - Less Slack

Participation Rate Prime Age Women 75.4% v 75.5% - More Slack

Employment Ratio Prime Age Workers 77.6% v 77.4% - Less Slack

Median Duration of UE (weeks) 14.7 v 15.2 - Less Slack

The bottom line is that Williams and the FOMC are likely correct, there is limited labor slack as evidenced by our index above the '00s expansion peak. The St. Louis Fed wrote a report this week that concluded 7.7 million workers 'exited' the labor force and forecasted 3.7 million returning by June '22. That argues for some rapid payroll gains alongside a permanent reduction in slack.

Labor Force Exits and COVID-19: Who Left, and Are They Coming Back?

What We Know About the Labor Market in September

The best indicator through the pandemic to forecast headline payrolls has been continuing claims. We expected a large drop this month with the expiration of expanded unemployment benefits, however because of reporting lags and perhaps because states may be taking the Biden Administration up on their offer to spend stimulus funds on extending the program (CA & NY are suspects), the numbers haven't fallen as much as we expected. Consequently, there is no clear reading from this indicator. Tomorrow's report may provide additional clarity.

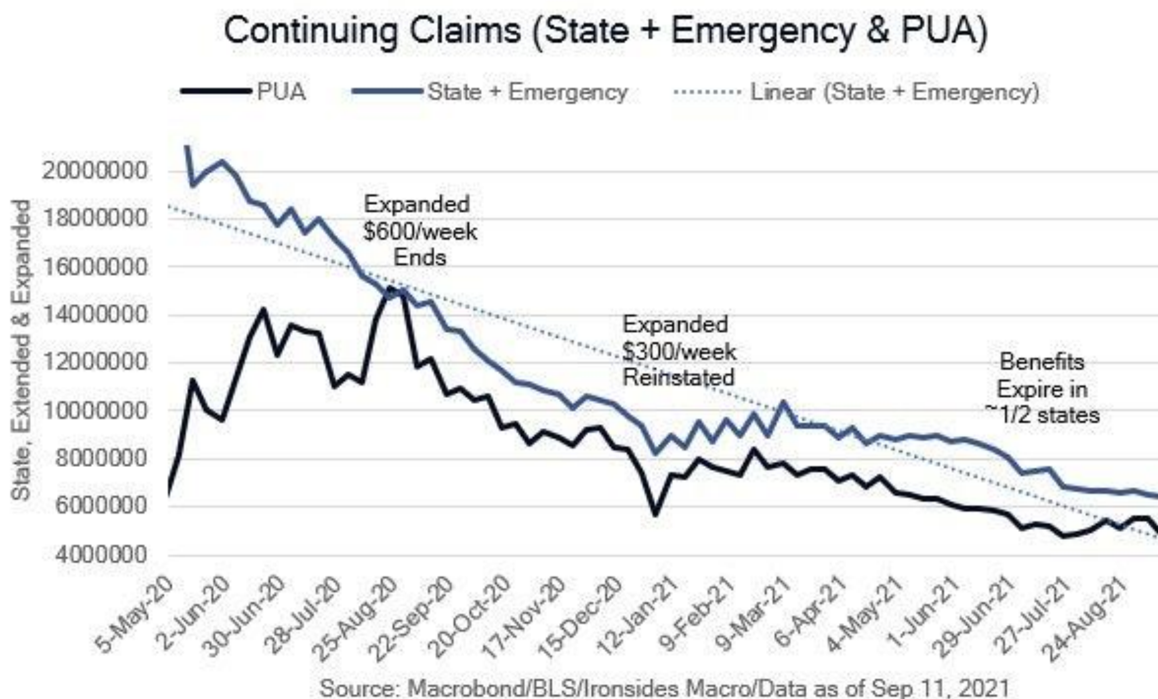

Figure 2: There was a downtick in pandemic continuing claims in the first week after expiration, but lags in reporting make this indicator less useful this month. I'll Tweet out an updated chart after tomorrow's weekly claims report.

The Conference Board's Labor Differential is highly correlated with the U3 and U6 rates, and it remains strong and points to significant downside for those rates. Our model for the U3 unemployment rate using the labor differential as the independent variable expects declines to 4.3% and 7.6% for the U3 unemployment and U6 underemployment rates. The spread between the 3.5% '10s cycle low in U3 and the 4.3% rate is a decent approximation of hysteresis, implying permanent damage to labor demand was limited. We wouldn't make too much of the uptick in jobs hard to get in September from 11.2% of respondents to 13.4%, given the increase in jobs plentiful from 55.6% to 55.9% and the end of expanded UI benefits. It could just be that hiring picked up and a decent amount of the record 10.9 million August job openings got filled in September.

Figure 3: Please note we inverted the U6 underemployment report to make the chart easier to interpret. The labor differential is respondents to the survey describing jobs as plentiful less those saying they are hard to get.

The wage outlook remains strong, and the August Atlanta Fed wage tracker showed additional strength drive by the low-end wages, job switchers, hourly workers, and the service sector. The nonsupervisory average hourly earnings series in August showed strong momentum in our 'China shock' sectors. With continued supply chain

bottlenecks and the September ADP report showing an increase in manufacturing hiring this trend likely continued in September.

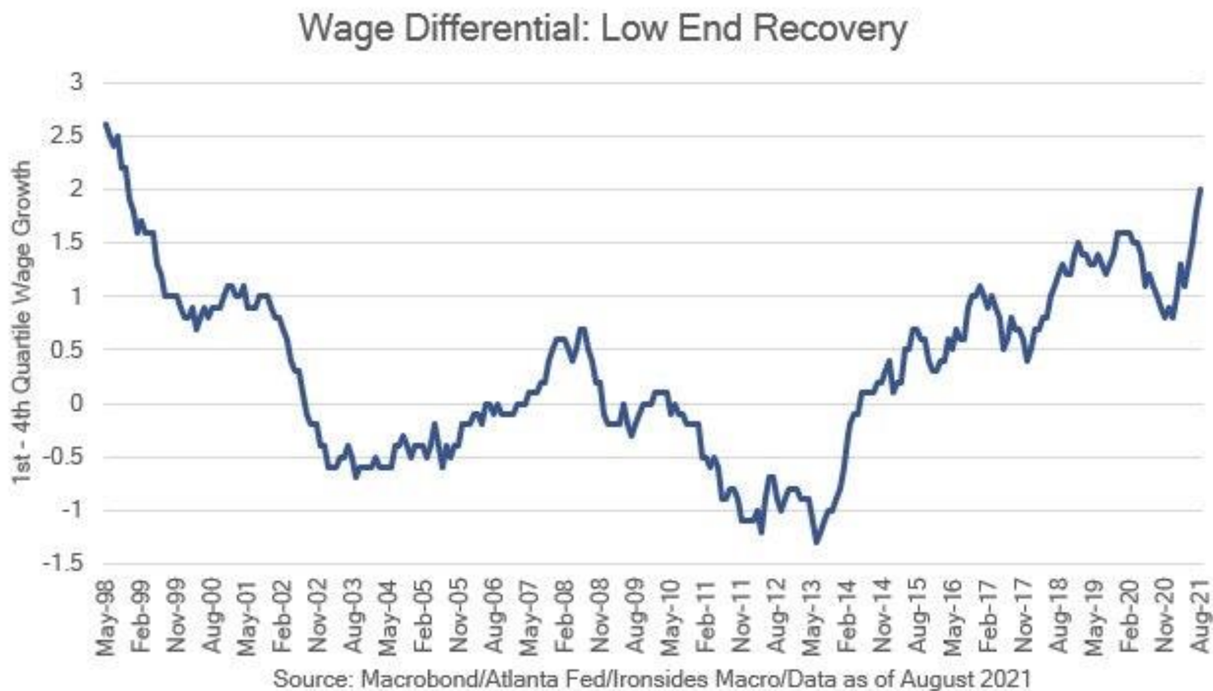

Figure 4: The Atlanta Fed Wage Tracker corrects for bias in other series' including demographic trends. They define the 1st quartile as low wages and the fourth has high wages. The bottom of the spread coincided with the end of extended UI benefits following the financial crisis.

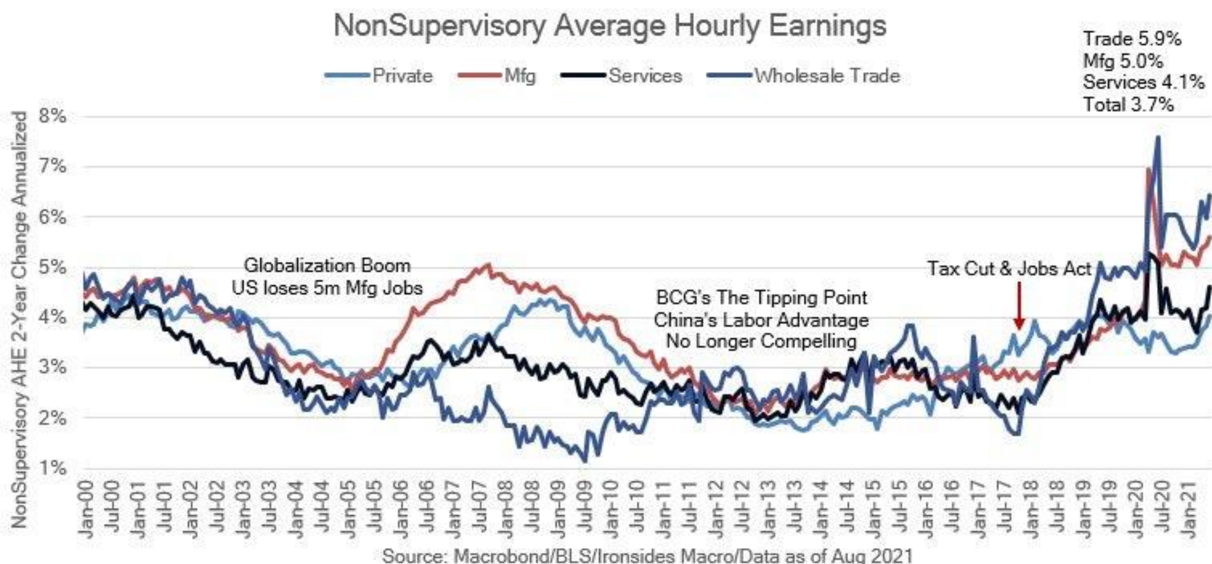

Figure 5: Manufacturing wage growth fell during the early '00s and were sluggish for most of the '10s. Like the disinflationary impulse from core goods prices, soft manufacturing appeared to be the marginal factor that slowed aggregate growth.

Additional Thoughts

- Education jobs surprisingly did not increase in August despite school reopening. The Bureau of Labor Statistics was dumbfounded and wrote a note with the report that they were having issues with seasonal adjustment factors. Look for a sharp recovery in this category.
- There are a number of street economists who expect a sharp increase in leisure & hospitality due to the drop in Covid cases and end of expanded unemployment benefits. The ADP report showed decent gains in this category.
- We do not like the ADP series; they have a robust database, but Moody's Mark Zandi created a model that attempts to replicate the BLS report. Nonetheless, the BLS report does not provide size of business details and uses the birth/death model to guesstimate small business jobs. Small businesses have been far more aggressive in rehiring workers than large businesses. However, in the September ADP report most of the jobs came from large businesses, which hints that the BLS report may be strong.
- The August net employment number will likely be revised higher; this is a long running pattern.

Look for strong wage growth, some return to work for prime age workers and females in particular and some evidence the labor bottlenecks are clearing. The risks for the headline are for a better number despite the confusing claims data. Tomorrow's claim report may provide additional clarity provided pandemic unemployment assistance and emergency continuing claims fell sharply in the week ended September 18.

Final Thoughts on Labor Dynamism

It might be hard to detect in the below chart, and with the effects of the pandemic lingering it may be premature to reach this conclusion, however, we believe the pandemic accelerated the trend of improving labor market turnover. If we are correct, this is positive for sustainable productivity driven wage growth. Reallocation is the quarterly sum of hiring and separations as a percent of the labor force. It was seriously impaired by the financial crisis and the recovery was tepid (~25bp/year) until the end of extended UI benefits at the end of 2013. There was another level shift higher after the Tax Cuts & Jobs Act. The financial crisis trapped workers in their

homes with negative equity, but work-from-home has the opposite effect. If dynamism improves sharply with the end of expanded UI, this is very good news for the economic outlook and could be an offset to higher trend inflation.

Figure 6: Labor reallocation appears to be improving, we will be watching carefully to see if the end of benefits had a similarly positive effect as was the case in 2014.

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