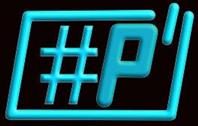


Soft vs Hard Landing

Navigating the US Job Market

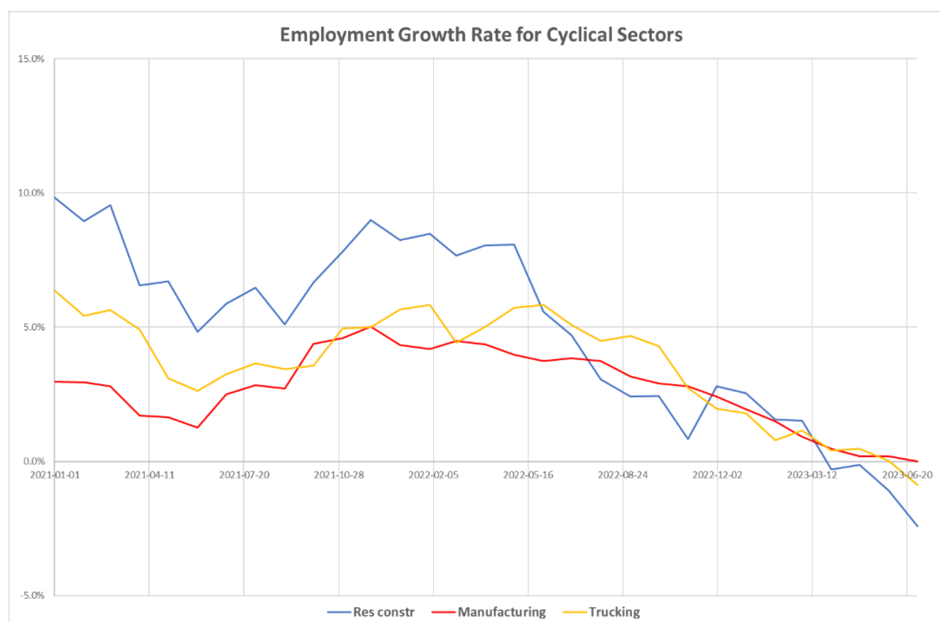
T. Gacon for PragmaOne.com, August 2023.

As soon as summer 2022, most economists speculated that a recession would hit the US during 2023. Nevertheless, the American economy proved more resilient than initially predicted, with a strong Labor Market and historically low unemployment with an unemployment rate of 3.5%. Most market participants are now betting on a soft landing, that the US economy can avoid recession. This paper focuses on the US Labor Market to identify if a gradual weakening is building under the surface.

The Cyclical Employment View

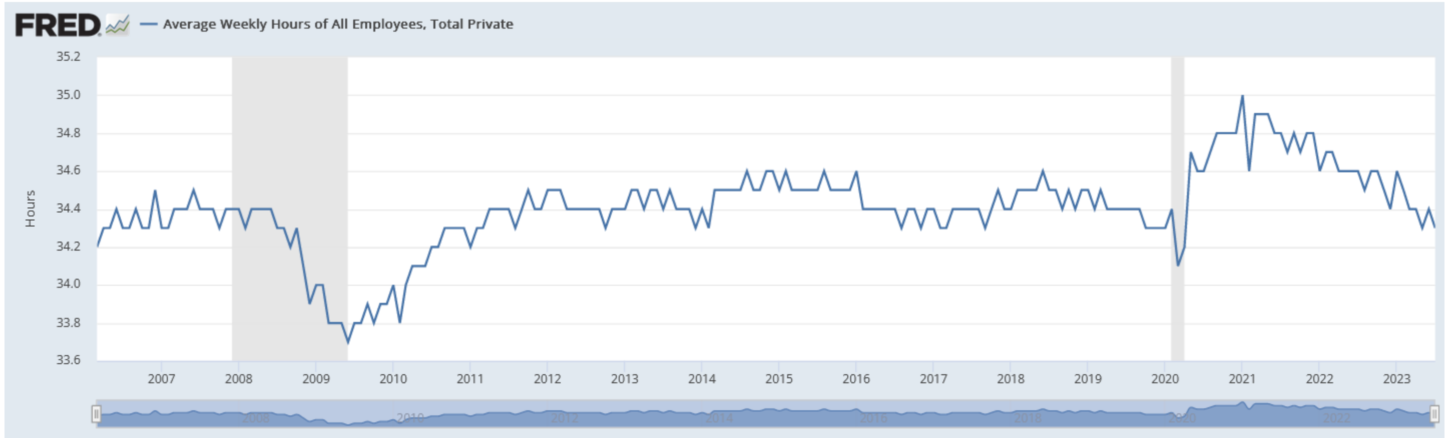
Unemployment in the US was reported at 3.5% in July 2023, and the four-week average Initial Claims is still well under 250,000. Both statistics indicate a strong and resilient labor market far from recession levels.

However, it is interesting to focus on cyclical economic sectors, which are usually the first impacted by a slowdown and shed employees before the rest of the economy. The below graph displays the employment growth for residential construction, trucking, and manufacturing (measured over six months and annualized from seasonally adjusted employment time series). We can see that residential construction has been destroying jobs since April 2023, trucking since June, and manufacturing is on the verge of recession. Those observations are consistent with poor manufacturing PMIs and communications from shipping and trucking companies that transported volumes are significantly down. Thus, despite strong headline statistics, some cracks have started to appear in the US job market.

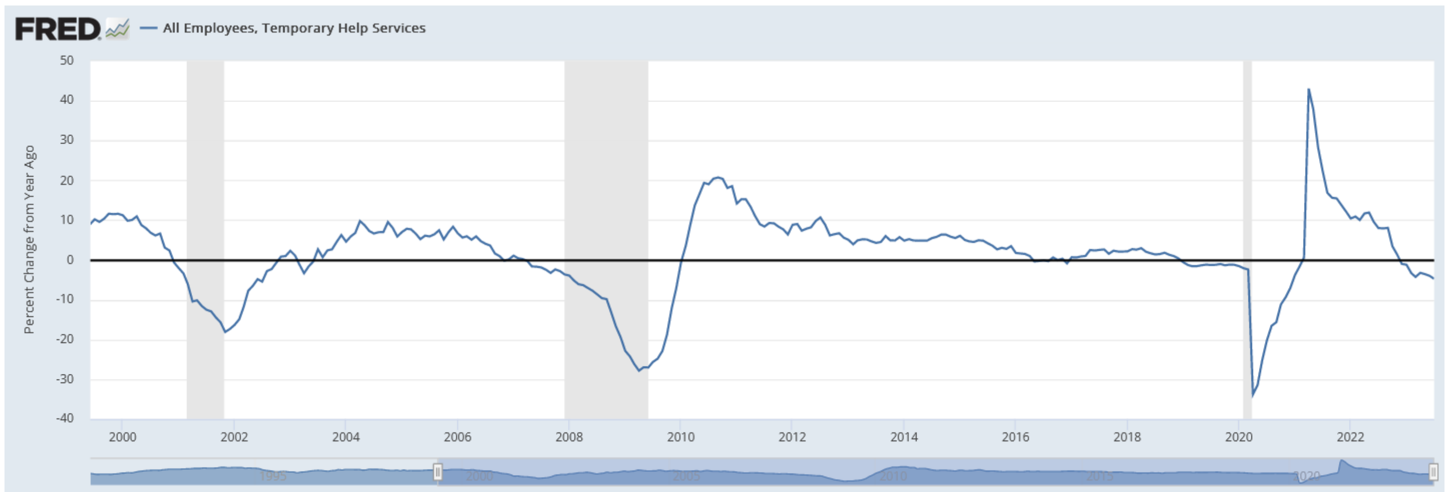


Adjustment Variables

In the past, companies have encountered difficulties in hiring qualified workers, and consequently, they are reluctant to proceed with mass layoffs at the first signs of a slowdown. They are hoarding workers. Corporations have, however, other means to adjust their staffing costs. First, they can reduce the number of hours per week required from their employees: we note that the weekly hours worked have decreased gradually from 34.8 h/w to 34.3 h/w since 2021.



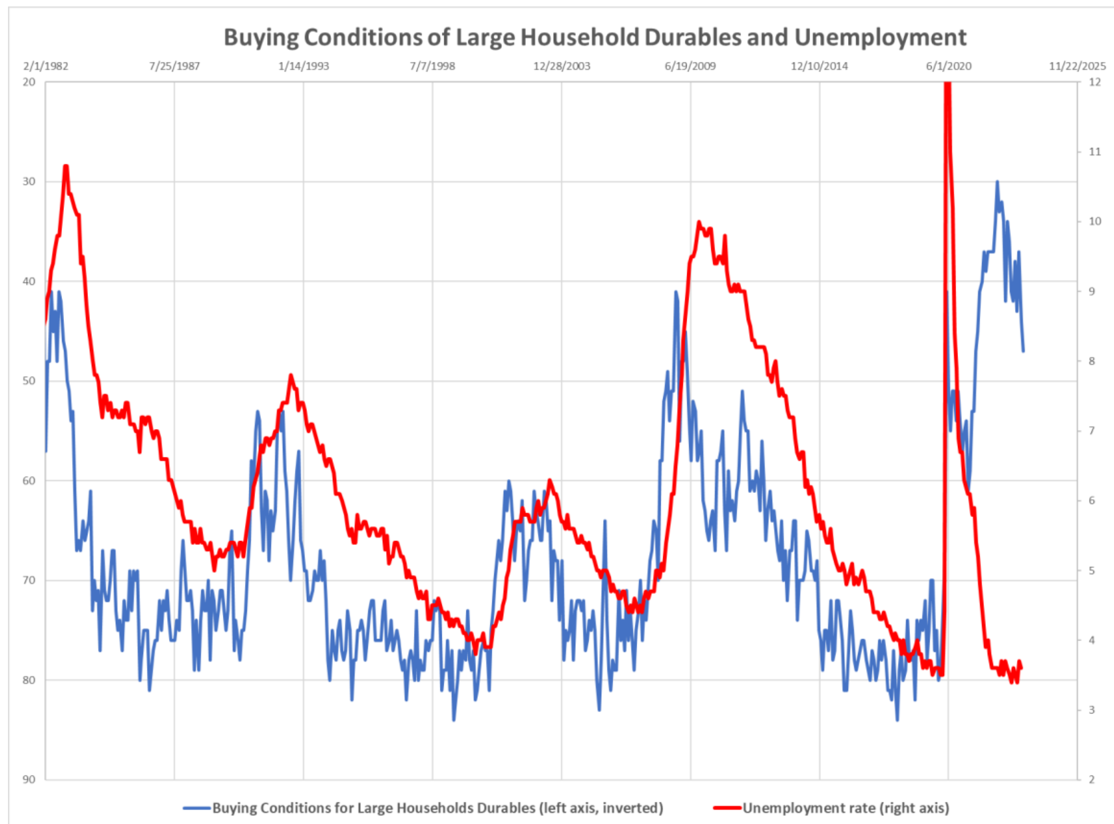
Second, they can reduce the number of temporary employees they employ when the economy is expanding. We observe that the growth rate of temporary service employees has become negative at the end of 2022, which means that temporary jobs are being destroyed.



But those measures only have limited effects and are foreshadowing more drastic actions when the corporate profit margins start to decline.

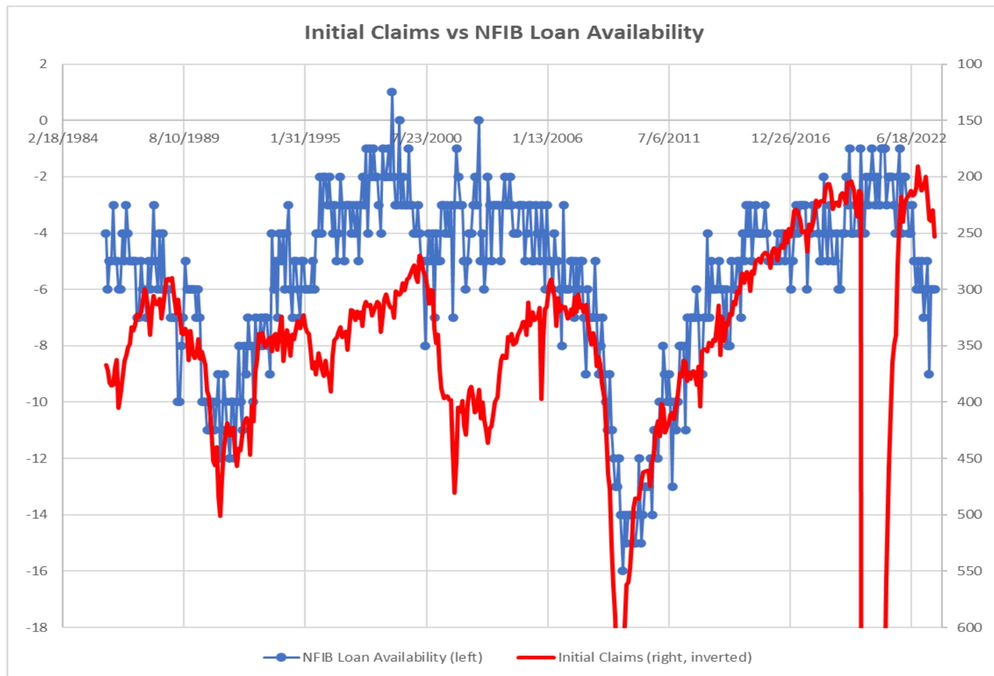
Employment and Consumer Sentiment

The Michigan Survey publishes subcomponents of its consumer confidence index. One of them focuses on the buying conditions of large household durables. We can identify on the below graph that this index (in blue, left axis inverted) tends to be related to the US unemployment rate: when consumers are confident that they can buy expensive household items, unemployment is low, and when buying conditions are poor, unemployment deteriorates. It is interesting to note that the behavior of this confidence index tends to precede moves in unemployment. If the long-term relationship between those variables still holds, we should expect to observe a rise in US unemployment.



Employment and Credit Standards

We know that access to credit is a critical element to ensure GDP growth. However, the Senior Loan Officer Opinion Survey (SLOOS) on bank lending practices, released quarterly, or the NFIB survey for loan availability (blue curve below), released monthly, both point to a tightening of credit and a more difficult environment to borrow. Those conditions usually coincide with a rise in unemployment claims (red curve, right axis, inverted). We can expect credit conditions to tighten further after the banking events observed in March 2023 with the defaults of several US lenders, with negative consequences for the employment market.

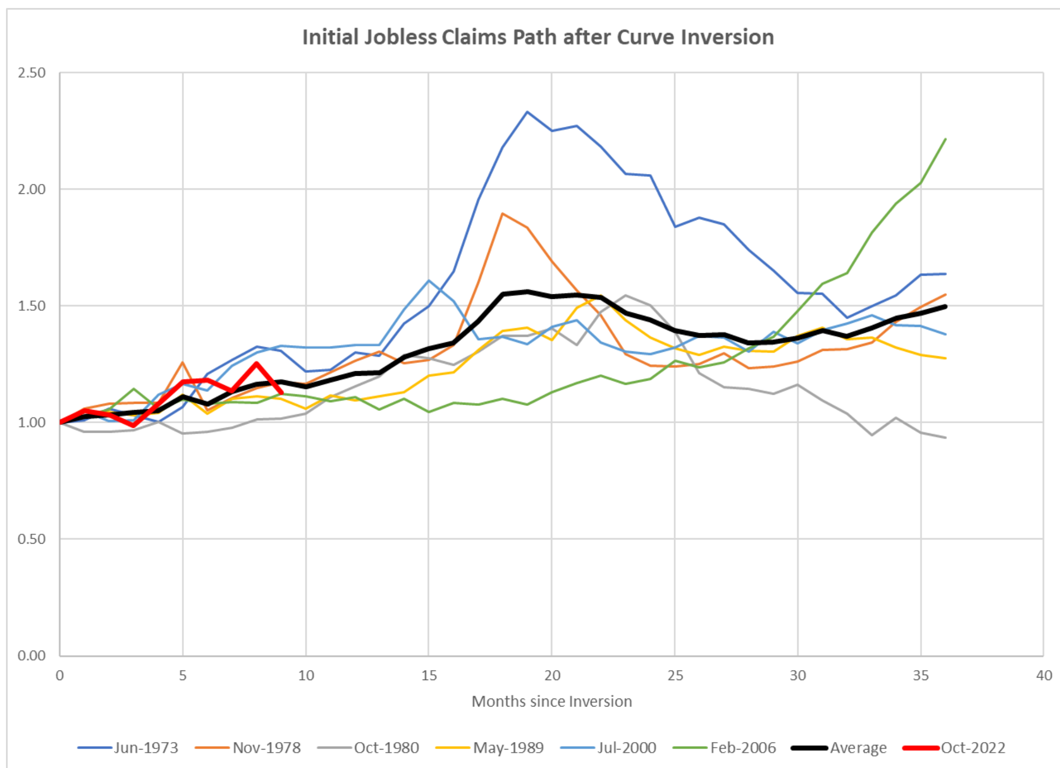


The Path of Initial Claims

A rate curve inversion is a strong indicator of economic recession, as demonstrated by Estrella and Mishkin (1998). We decided to study the evolution of initial claims during those inversion periods, from 1973 until 2022, excluding the COVID era. Our curve indicator is the spread between the ten-year and three-month government rates, which became negative in October 2022 for the most recent inversion episode. On the graph, the abscissa represents the number of months since the inversion began. The bold black line represents the average normalized path of initial claims (normalized to the initial claims at the start of the inversion episode). We can observe a progressive increase in the initial claims after the inversion of the Treasury Curve begins. On average, the peak of the job market slowdown is observed 18 months after the beginning of the rate curve inversion.

The fastest decline of the job market occurred in the period starting in June 1973 and the slowest in February 2006: the GFC was a slow-motion crisis and took a long time to unfold. The bold red line represents the most recent inversion episode starting in October 2022. We can notice a similar trend of the current initial claims path versus the average behavior.

Though the job market seems still strong, we should expect a continuous deterioration, with the 4-week average initial claims moving above 250,000 by the end of Q1 2024, if the average behavior is to be observed.



In conclusion, we believe that several hints from the cyclical economy, credit availability, consumer sentiment, and rate curve inversion all point to a progressive deterioration of the US job market, which should lead to a recession during the first semester of 2024.

References

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